

Reinhart

Attorneys at Law

RFP Response for Fiduciary Legal Counsel



Exhibits

Firm Resume **Exhibit 1**

Organizational Chart **Exhibit 2**

Professional Resumes **Exhibit 3**

Presentation: Fiduciary Duties of Pension Board **Exhibit 4**

Article: IISD Report Re. Fiduciary Duties **Exhibit 5**

Article: Reclaiming Fiduciary Duty Balance **Exhibit 6**

Questionnaire

Organization and Management

1. Contact and Company Information:

Name of Firm: Reinhart Boerner Van Deuren s.c.

Mailing Address: 1000 N. Waters Street, Suite 1700

City: Milwaukee

State: WI

Zip Code: 53202

Phone: (414) 298-1000

Fax: (414) 298-8097

Federal Employer Identification Number: 39-11206909

Contact Person(s):

Name: Jussi P. Snellman

Phone: (608) 229-2243

Title: Shareholder

Email: jsnellman@reinhartlaw.com

2. Give a brief history of your firm, including the year the firm began providing legal services. Give specific details with regard to the nature of services provided, with special attention to public sector experience and specific experience with public pension plans.

Reinhart was founded in 1894 in Milwaukee, Wisconsin. Reinhart is a full service law firm with more than 200 attorneys, and ranked in the top 250 U.S. law firms by the *National Law Journal*. The firm has 96 lawyers who were awarded the Best Lawyers in America designation. The firm has offices in Madison, Milwaukee and Waukesha, Wisconsin; Chicago and Rockford, Illinois; Denver, Colorado; and Phoenix, Arizona. A detailed firm resume is attached as *Exhibit 1*.

Our firm is organized in the following major categories:

- Advertising, Media and Entertainment
- Banking and Finance
- Business Reorganization
- Corporate Law
- Employee Benefits/Pension Funds
- Food and Beverage
- Health Care
- Institutional Investor Services/Pension Funds
- Intellectual Property
- International
- Labor and Employment
- Litigation
- Manufacturing
- Product Distribution and Franchise
- Real Estate
- Tax
- Tax Exempt Organizations
- Trusts and Estates

Reinhart has one of the largest employee benefits/pension fund law practices in the country. Our Employee Benefits practice was established more than 40 years ago and currently includes more than 30 professionals. We represent pension plan clients on a full range of benefits, fiduciary, investment, litigation, corporate governance, tax and compliance matters in more than 40 states and in Europe.

Our attorneys have considerable experience advising public pension fund clients on fiduciary matters. Currently, we represent more than 50 public pension funds.

We also represent more than 80 multiemployer funds and many pension and other retirement plans sponsored by other entities such as corporations. Our attorneys have experience representing all types of plan clients, including defined benefit plans, defined contribution plans, group health plans, hybrid plans, group life insurance plans, and employee-funded reimbursement accounts.

Our Employee Benefits department includes Reinhart Institutional Investor Services (RIIS). RIIS offers an expanded level of service which includes the investment and fiduciary side of our pension practice. RIIS is headed by Jussi Snellman. RIIS uses the expertise of our firm's employee benefits, real estate, securities, business law, bankruptcy, litigation, tax and international practice professionals to provide seamless representation for pension funds on all their legal matters.

3. Describe in detail your firm's organizational structure, including the number of attorneys, the location of the firm's offices, and the number of attorneys specializing in litigation and their location. Identify any controlling stockholders, parents, subsidiaries, affiliates, partners, general partners, or principals (all such individuals or entities hereinafter collectively referred to as the "firm"). Provide each identified entity's involvement in providing legal services within the last five years. Provide a complete listing of any affiliated companies or joint ventures and the nature of services provided.

Organizational Structure: Service Corporation

Number of Attorneys: 200

Office Locations: Madison, Milwaukee and Waukesha, Wisconsin; Chicago and Rockford, Illinois; Denver, Colorado; and Phoenix, Arizona.

Identify any controlling stockholders, parents, subsidiaries, affiliates, partners, general partners, or principals: None. Reinhart is a partnership, where each partner has a role and a vote in the affairs of the firm.

Affiliated Companies/Joint Ventures: None.

4. Provide an organizational chart. Include the number of professionals in total. Also provide a short biography of your key attorneys including their title, function, number of years with your firm, years of experience, educational background and professional affiliations.

The firm has approximately 200 attorneys, and 170 non-attorney support employees. Please see *Exhibit 2* for a firm organizational chart.

Below are short biographies of the key attorneys for fiduciary representation. Please see *Exhibit 3* for full biographies.



Jussi P. Snellman is co-chair of RIIS. Jussi has advised dozens of pension clients in more than 1,000 investment transactions over the past 20 years. He devotes his practice to representing institutional investors in private market fund transactions, including private equity, real estate, venture capital and special situations, fund of funds and hedge funds, and negotiation of investment agreements. Also included in his practice is advising

investors on other investment related matters, such as custody agreements, securities lending, investment management agreements, secondary sales of assets, manager transitions, bank collective investment fund investments, single-investor "fund of one" partnerships, compliance with public records laws and sovereign immunity, and workouts involving GP removal or replacements. Prior to joining Reinhart, Jussi represented private equity fund managers while at Kirkland & Ellis & Arnold & Porter in Denver and Washington, DC. He has been with Reinhart since 2005, and advising institutional investors since 1995. He is licensed to practice law in Wisconsin, Colorado and Texas.

Education: J.D., University of Michigan Law School; B.A., *magna cum laude*, Southern Methodist University; Phi Beta Kappa



Andrew O. Christianson, shareholder in the firm's Employee Benefits, RIIS, Corporate Law and Securities practices. Andy is a trusted adviser to domestic and non-U.S. governmental pension plans, insurance companies and other institutional investors in structuring and negotiating private equity, hedge fund and alternative investments. Andy also represents public and closely held companies on a range of transactional and compliance

matters, including securities compliance, corporate governance, M&A and other corporate transactions. He has 14 years of legal experience and is licensed to practice law in Wisconsin.

Education: J.D., *cum laude*, University of Wisconsin Law School; B.B.A. in Finance, Investments, and Banking, University of Wisconsin-Madison



Stacie M. Kalmer is an associate in Reinhart's Employee Benefits Practice counseling a wide variety of multiemployer, corporate and governmental plan clients on an array of employee benefit plan issues. She advises clients on plan design and administration and also advises plan fiduciaries on fiduciary compliance and corporate governance issues under federal and state law. Ms. Kalmer primarily serves the following industries:

Qualified Retirement Plans; Health Plans; Employee Benefits Plans in Mergers and Acquisitions; Taft-Hartley Multiemployer; and the Affordable Care Act.

Education: J.D., magna cum laude, Marquette University Law School; B.A., University of Wisconsin-Madison



Jessica P. Culotti is a shareholder in Reinhart's Employee Benefits Practice and RIIS. Jessica advises fiduciaries and plan sponsors in all areas of employee benefits, including plan administration, fiduciary obligations and compliance with the Internal Revenue Code, ERISA and other applicable federal and state laws. Jessica has extensive experience providing tax and benefits guidance as well as fiduciary reviews and best practices to public retirement plans, single employer plans and Taft-Hartley plans. Jessica assists public retirement plan clients in multiple states. She has more than 10 years of legal experience and is licensed to practice law in Wisconsin, Minnesota and Colorado.

Education: J.D., magna cum laude, University of Wisconsin Law School; B.A., University of Minnesota



Nicholas W. Zuiker, associate in Reinhart's Employee Benefits Practice and RIIS. Nick analyzes and negotiates the legal and economic terms of investments in private equity funds, hedge funds and alternative investment vehicles on behalf of domestic and foreign institutional investors. Also included in his practice is advising investors on other investment related matters, such as custody agreements, securities lending, investment management agreements, secondary sales of assets, manager transitions, compliance with public records laws and sovereign immunity. In addition, Nick advises public pension fund clients on fiduciary, tax and governance issues. He has four years of legal experience and is licensed to practice law in Wisconsin.

Education: J.D., cum laude, University of Wisconsin Law School (Order of the Coif); B.A., summa cum laude, University of Minnesota

5. Describe any changes in the firm's ownership structure, core line of business, or senior staffing within the past 3 years. Do you anticipate any such changes in the future? If so, describe.

There have been no significant changes in the firm's ownership structure, core lines of business or senior staffing within the past three years. We do not anticipate any change changes in the near future.

Qualifications and Staffing

6. Identify the initial year and briefly summarize the history of your firm providing legal advice to any other pension (public or private) plan. List the full name, address and phone number of each of the pension plans and telephone number of the Executive Director or Chief Executive Officer.

Our firm began providing investment counsel services: 1963 (Pension plans generally); mid-1970's (ERISA topics); 2006 (Reinhart Institutional Investor Services: Public Pension plan focus).

Representative clients:

Currently, we represent more than 50 public pension funds. For example, our public pension fund clients include the following:

- Connecticut Retirement Plans and Trust Funds
- Florida State Board of Investment
- Hawaii Employees' Retirement Systems
- Kentucky Retirement Systems
- Kentucky Teachers' Retirement System
- Maryland State Retirement and Pension System
- Milwaukee County Employees' Retirement System
- New Mexico Educational Retirement System
- New York City Employees' Retirement System
- North Carolina Retirement Systems
- Pennsylvania School Employees' Retirement System
- San Francisco City & County Employee Retirement System
- State of Hawaii Employee Retirement System
- State of Michigan Retirement System
- State of New Mexico, Public Employees Retirement Association
- State of Wisconsin Investment Board
- Teachers' Retirement System of the State of Illinois
- Universities Superannuation Scheme (USS)

In addition, we represent more than 100 non-governmental collectively bargained funds throughout the country. Please see our references response for selected references and their contact information.

7. Identify and state qualifications and experience of attorneys and professional personnel who would be assigned to staff this engagement, as well as current and planned role the individual will play, relative to this assignment.

See *Question 4* for identities of attorneys and professionals who would staff this engagement. Each of the identified attorneys is anticipated to be fully engaged in staffing this assignment. We

anticipate Ms. Kalmer and Ms. Culotti to provide the bulk of the representation, with Ms. Reeves providing significant support.

8. Explain your firm's procedures in the event that a key person assigned to the proposed engagement leaves your firm during the engagement.

The senior attorneys included in the proposal have worked together for more than 10 years serving over 30 public pension plan clients. As a result of our busy practice serving these clients, we work as teams and our team members are accustomed to collaborating on client matters and drawing upon each other's areas of expertise. Additionally, the team approach allows a team member to always be available and to fill in at meetings if there are conflicts with other members' schedules. In the event of any attorney turnover, Reinhart's project staffing and workload management methods, outlined below would ensure seamless execution of all matters. Additionally, our client references can attest to our high standards of service, quality and execution.

The client team would be structured to provide back-up coverage on all matters. We have depth of experience at all levels, so substitutions can easily be made at the senior, junior or associate levels. Reinhart's practice is to staff matters with at least two attorneys, though clients are not billed for duplicative work. Documents and emails are circulated to all attorneys assigned to a matter in order to keep everyone up to speed on developments and facilitate transfer of the file if needed.

Legal Services

9. Describe in detail your firm's understanding of the services requested by this RFP. Provide a narrative that supports why your firm believes that it is qualified to undertake the proposed engagement.

Reinhart's fiduciary counsel services team provides a wide range of services necessary to help any public pension fund fiduciary meet his or her fiduciary responsibilities. From trustee and staff training to advice on specific situations, Reinhart has the expertise to help on matters relating to fiduciary duties.

Reinhart's Employee Benefits department has extensive experience representing public pension plan fiduciaries. Reinhart's fiduciary counsel services include the following:

Fiduciary Reviews: We assist clients with the review of fiduciary issues relating to investments, ethics codes, delegation and monitoring of duties, plan administration and compliance. We have extensive experience in fiduciary issues involving public pension plans. We work closely with public pension plan fiduciaries to ensure that they take the steps necessary to make "procedurally prudent" decisions with respect to employee benefit plans.

Since retained as fiduciary counsel, we have reviewed many policies and procedures utilized by the client, as well as periodic revisions to them. We have considered Illinois, Texas, Wisconsin and other state statutes, the client's guidelines and policies, as well as best practices.

Fiduciary Training: In addition, Reinhart provides a fiduciary training program for public pension plans. We have assisted General Counsel on several training projects involving Illinois, Texas and Wisconsin law (and other states), assisting fiduciaries in understanding responsibilities inherent in being a fiduciary of a public pension plan, examining procedures and possible actions for the fiduciaries to reduce or avoid risk and reviewing administrative procedures and policies. A sample fiduciary training presentation given to another pension plan is at *Exhibit 4*, and the IISD report that our attorneys authored that summarizes evolving trends in fiduciary duties is at *Exhibit 5*.

Mr. Johnson is a nationally recognized expert on training public pension fund trustees and employees regarding their fiduciary duties and devotes a great deal of time speaking on the subject. He has made fiduciary presentations at the Stanford Fiduciary College, National Association of Public Pension Attorneys, Wisconsin Planned Giving Council, International Foundation of Employee Benefit Plans, Principles of Responsible Investment Conference (New York City), RI Americas 2013 Conference (New York City), International Institute for Sustainable Development (Beijing), Intentional Endowment Conference (Phoenix), and Columbia University.

Fiduciary Advice: Reinhart regularly provides legal opinions and advice to clients on specific issues relating to fiduciary duties. Issues for public pension fiduciaries can range from advising on how strategies might subject fiduciaries to legal exposure for unreasonably favoring one group of beneficiaries over another to employer funding obligations or trustee conflicts of interest. Our strength is the level of experience we can bring to providing fiduciary advice. We regularly publish articles and provide speeches on fiduciary duty topics to the International Foundation of Employee Benefit Plans.

For example, *Exhibit 6* contains an article that provides fiduciary advice regarding investment matters and intergenerational equity.

10. Provide a Summary of Significant Fiduciary Work

The following is a description of some projects or categories of fiduciary projects we have completed on behalf of our pension clients:

1. The Investment Committee of one of our public pension fund clients was deadlocked on developing a strategy to implement a decision to allocate assets to alternative investments. Reinhart was asked to assist the Committee in resolving the situation. As an expert on alternative investments, legal matters and fiduciary duty, Reinhart made a presentation to the Committee on procedures used by other pension funds in approaching alternative investments and worked with the Trustees to reach a prudent decision that broke the deadlock. The Committee ultimately recommended, and the Pension Board adopted, the approach that was developed with Reinhart's assistance.
2. We analyzed proposed State legislation that would have required our pension fund client to accept promissory notes issued by the State in lieu of required employer contributions. We provided the client with a Memorandum raising fiduciary and tax issues presented by the legislation, which the client was able to use to convince the legislative proponent to

not proceed with the legislation. The State required employer contributions were ultimately made.

3. We conducted an independent review of an ethics compliance issue for the Audit Committee at a public pension fund client. The project involved investigation of allegations, witness interviews, analysis of applicable legal principles and preparation of a privileged report. The subject of the review resigned after the report was prepared, but before it was formally presented to the Audit Committee.
4. We have assisted General Counsel in a number of evaluations to determine whether the Trustees, including newly appointed Trustees, are involved in conflict of interest situations under State law or the Board of Trustees Ethics Policy. The laws are very intricate and require precise analysis. A common finding is that the Trustee is eligible to serve as a Trustee but may want to take certain actions in order to avoid issues for Client or others. In most cases involving potential conflicts with respect to Trustees or prospective Trustees, we prepared lists of suggested steps to help mitigate potential conflict of interest issues and suggested that the Trustee, Client and others consider following those steps.
5. We reviewed many policies and memoranda regarding items on Board agendas.
6. We prepared training topics for annual Trustee training.
7. A party requested that the Client Board make a payment from Client to the party in connection with a claim. We analyzed the claim extensively, obtained information from the party and his counsel and presented our suggestions to the Trustees for review and evaluation. We prepared correspondence, and distributed confidential materials evaluating the claim including memoranda, a time line, analysis of insurance policies, a review of the application of various State statutes and flowcharts to assist analysis.
8. We evaluated methodologies and practices used by other retirement systems in reimbursing fiduciaries for claims.
9. We reviewed the Board's Ethics Policy, and provided suggestions to incorporate in the revised Board of Trustees Ethics Policy.
10. With General Counsel, we prepared revisions to the Employee Ethics Policy.
11. With General Counsel, we prepared revisions to the Code of Ethics for Contractors. These amendments were adopted and implemented.
12. We reviewed questions involving trust law, fiduciary duties, State law and compliance with the Internal Revenue Code with respect to various Client matters.
13. We reviewed a number of issues relating to interpretation of State law and Client policies and application to Client staff.
14. We reviewed application of legislation to Client.
15. We documented for General Counsel our views on application of fiduciary standards to Client investment decisions.
16. We reviewed the standards used in an internal Client investigation. We evaluated and provided commentary regarding the sufficiency of an investigation conducted by Client.

17. We described potential methods by which the Board could provide oversight of the TEAM program.
18. We evaluated fiduciary oversight related to extension of investment consultant contracts.
19. We researched and analyzed Client-Care statutory funding requirements and applied them in light of fiduciary duties for the Board to provide Client-Care benefits.

11. Describe the anticipated role of the client's Office of Legal Counsel's Office in your firm's provision of the anticipated legal services.

For most clients for whom we offer fiduciary services, we take guidance from, and work directly with, the office of legal counsel. However, with several clients (e.g., Texas Teachers), the board of trustees has engaged us to represent them (separately and independently from representation that the office of legal counsel provides). Those clients asked us to interface directly with the board of trustees, and we honor that request. Frequently, for those clients, we will work closely with the general counsel in addressing questions that the board of trustees may pose.

12. Describe how your litigation practice group fits within the context of the firm. What conflicts of interests could exist between the litigation practice group and the clients it represents? Please explain in detail how these potential conflicts are managed.

Reinhart's litigation group provides ongoing support to public pension plans and other institutional investors whenever a need arises. They have engaged with the SEC, negotiated key person event dissolutions, worked on for-cause key person removals, fought bankruptcy preferences, challenged legal fees paid to class action plaintiff firms, and advised on settlements and releases. Our litigation group is consistently ranked among the best by our clients and peers. For example, Benchmark Litigation 2018 (which identifies the leading U.S. trial attorneys and firms at the local and national levels) has named Reinhart a "highly recommended" law firm.

13. Describe other services besides fiduciary counsel offered by your firm. Please provide a listing of your firm's divisions. Is it anticipated that the entity the System is considering retaining may use the services of affiliated firms? Do you consider this a conflict of interest? Why or why not?

In addition to fiduciary counsel services, Reinhart strives to be a one-stop shop for pension plans and their legal needs. We advise pension plans on all of their other needs, including:

- Investments (hedge funds, private equity, real asset, and other)
- Contracts (e.g., securities lending, custody agreements, ISDA)
- Tax matters, both domestic and foreign
- Corporate Governance and sustainable practices
- Litigation, including evaluation of the merits of opting out of securities class actions (but we do not provide contingent-fee securities litigation services)

No affiliated firms or subcontractors will be used to provide services to the client.

Diversity

14. Describe your firm's diversity policies and practices. If your firm has received any awards or recognition for its efforts to ensure diversity of your professional and administrative workforce, please describe.

Reinhart understands the value of diversity, and we are fully invested in maintaining an environment that attracts and sustains diversity of gender, ethnicity, religion and sexual orientation among our staff. A diverse workforce provides the highest value for client services by forging solutions to problems from different perspectives. Likewise, our vendors best serve us when they represent a diverse supplier network for goods and services needed by the firm. Reinhart is committed to several related objectives, including building relationships in the community, law schools, and ethnic bar associations. Through our work, we seek to provide opportunities for, and to promote the awareness of, diversity.

Several of our diversity initiatives focus on building relationships, which include:

Diversity and Inclusion Education

Reinhart is committed to ongoing learning and education via internal programs to promote an inclusive firm culture. Diversity and Inclusion was a cornerstone of our 2015 firm strategic planning retreat and subsequent programs.

Firm Diversity Committee

Reinhart is dedicated to providing programs, benefits and recruiting efforts focused on creating a more diverse workforce. Our Diversity Committee is made up of shareholders, associates and staff who are actively involved in professional and community events and maintain contacts in a wide-range of bar associations and other relevant organizations. They serve as mentors and resources for incoming attorneys of diverse backgrounds.

Professional Development of Minority Attorneys

Reinhart has and continues to foster professional development activities for attorneys of diverse backgrounds outside the law firm. We seek to identify innovative ways to work with other professionals to share skills and knowledge and expand the opportunities available, including the opportunity to participate in internal and external education programs. We have proudly sponsored programs for ethnic bar associations.

Local Community Organizations

Reinhart supports the Boys & Girls Club of Greater Milwaukee, Neighborhood House of Milwaukee, the Girls Scouts of America, La Causa and Centro Legal among other community organizations and our attorneys hold positions on a number of these and other boards. We frequently provide sponsorships for marquee events that provide important fundraising resources to these organizations. Since 2006, we have been involved with a scholarship program where Reinhart awards a scholarship to the Neighborhood House Youth of the Year. Our employees contribute annually to more than 100 community organizations.

Connecting Local Businesses

Members of our firm are frequent participants in state and local events that provide assistance to minorities, women and veteran-owned businesses. We offer presentations and counsel clients on implementing supplier diversity programs, including identifying ways for non-minority-owned companies to form relationships with minorities and/or women to capture business opportunities.

In addition to our community outreach, our Diversity Program focuses on providing opportunities and building relationships through several other channels, including:

Women's Initiatives

We have long been an advocate of women's initiatives and established the Reinhart Women's Forum (RWF) as a means to attract and retain professional women. RWF provides opportunities for women to network, mentor and share business skills and strategies. The RWF mentoring groups are comprised of senior, mid-level and junior attorneys from departments throughout the firm who meet regularly to discuss practice development and reputation building within the legal community. In addition, we have sponsored numerous conferences for women in the communities we serve.

Diversity in the Community

Reinhart strives to use our visibility in our communities to raise awareness of the benefits of diversity. Our work includes:

Sponsorship of Milwaukee Forum quarterly meetings - Reinhart has sponsored quarterly meetings for the Milwaukee Forum, which is a group dedicated to fostering relationships, building connections and encouraging dialogue and engagement with issues challenging the growth of diverse businesses and organizations in our community. Reinhart has been honored with special recognition for "support of the Forum's efforts to identify and assemble a diverse group of individuals who are committed to building a better community."

SCORE and the Milwaukee Urban League - Reinhart proudly sponsors SCORE SE Wisconsin and the Milwaukee Urban League. SCORE is America's largest volunteer business counseling service. The Milwaukee Urban League is the nation's oldest and largest community based movement devoted to empowering African Americans to enter the economic and social mainstream.

Diversity at Reinhart Institutional Investor Services, specifically

RIIS prides itself on being the most diverse practice group in the law firm. We have more women lawyers than men, and three of the attorneys who work on investments and fiduciary matters are non-white. By demonstrating success in our diversity, we both push and pull the entirety of the law firm in the right direction. Since Reinhart was established more than 100 years ago, and with senior partners having joined in the 1970s, it makes sense that we are mid-path along the journey from a white-male establishment to a multicultural, multiethnic and gender-balanced one. The support of clients for our diversity efforts, and specific requests to

work with a diverse set of attorneys, enables us to hire diverse members of the legal community, such as Ms. Reeves (featured elsewhere in this proposal). This is essential to our ability to continue to broaden our own diversity through a balanced hiring plan.

15. Describe the approach your firm will take to help the System control its legal costs.

We help our clients control legal costs in numerous ways. First, we are committed to a disruptive pricing model, charging well below what we believe most of our competitors charge. We are able to do this because we are based in a smaller market, and because we have so much experience in this area that we are able to provide our work in a very efficient manner.

We do not generally incur costs, as it is highly unusual for attorneys in this field to travel, and we do not charge for copies, printing, long-distance telephone, or similar overhead costs.

We seek to staff projects with the best combination of senior attorneys and experienced junior attorney resources, to produce the highest quality output, while maximizing cost efficiencies. We believe that this is the right way to proceed, because (a) having two attorneys generally maximizes the quality of the work product, and (b) efficiencies (both in cost to client, and efficient use of each attorney's expertise) are gained when the junior attorney performs tasks that are within their sphere of competence, freeing the more senior attorneys to focus on the more nuanced and complex aspects of the transaction. This is the legal equivalent of balancing equities and fixed income assets in order to maximize risk-adjusted returns.

Conflicts

16. Identify any actual, potential, or appearance of conflict of interest that may arise as a result of your selection to represent the System. Describe in detail the nature of the conflict and what consent would be required under state Rules of Professional Responsibility. Also, identify any representation within the last three years of (1) any school district or other employer covered by the System; (2) any labor organization, professional association or collective bargaining unit whose members are covered by the System; (3) any investment manager or private equity fund; (4) any individual or entity where the firm advocated positions that could reasonably be construed as being contrary to the interests of the System; and (5) any other state pension system or entity created under the Pension Code.

We do not anticipate any actual, potential, or appearance of conflicts of interest representing the client. We do not have any representations of the type identified in (1) - (5).

17. Identify any current professional or personal relationship of any nature whatsoever with any current or former member of the Board. Identify any other matters that would be required to be disclosed pursuant to the "Conflict of Interest" provision contained in the sample agreement enclosed in this RFP.

None.

Applicable Law

18. Explain your firm's knowledge of and experience regarding public sector defined benefit retirement plans and the qualified plan provisions of the Internal Revenue Code.

We have extensive experience representing qualified plans on tax, planning and operational matters, including analysis of general tax questions and Internal Revenue Services (IRS) qualification and compliance issues. With the IRS's increased focus on compliance with Internal Revenue Code (Code) requirements and Treasury regulations, it is more important than ever for qualified plans to assess plan documents, operations and administration for compliance issues. It is also critical to evaluate when, whether and how to best utilize the IRS's determination letter and correction programs when issues are identified.

19. Explain your firm's knowledge and understanding of the pension protection clause of the state constitution as it relates to the client.

Reinhart supports robust pensions because they are protected by law and in the long-term best interest of the community. It would be unethical, and against the interest of the community, to allow a pension plan for teachers to become insolvent or to be undermined (e.g., by COLA adjustments). Fortunately, the state constitution and state Supreme Court have affirmed the sanctity of the teachers' pension plans.

20. Explain your firm's knowledge and understanding of the state Pension Code as it relates to the client.

Reinhart works with the pension laws of multiple states, and therefore understand not only the specifics of individual laws, but also has a thorough understanding of trends and interpretations nationwide of analogous laws. This enables us to better serve the needs of each our clients. Without limitation, this includes:

- Jessica Culotti's and Stacie Kalmer's experience advising the County of Milwaukee, Texas Teachers, Illinois Teachers' Retirement System and others on their pension law compliance
- Jussi Snellman advising numerous clients, including Connecticut and Kentucky, in connection with proposals to reduce or change the type of pensions provided (similar to the state's Tier I, II and now III pension program).

21. Explain your firm's knowledge and understanding of other federal and state laws not specifically identified above, including but not limited to the qualified plan provisions of the Internal Revenue Code, ERISA, the Freedom of Information Act, the Open Meetings Act, and the Procurement Code. Indicate in your response whether your firm believes these laws do or do not apply to the client, and why.

Reinhart represents more than 30 public pension plans, in all areas of their operations. As part of this representation, we regularly work on the laws identified above (as well as analogous laws in other states). Other than certain parts of ERISA that exempt governmental investors from VCOC

rules, and other than the UBTI rules (and income tax generally) that the IRS has determined don't apply to governmental investors, the other enumerated laws would typically apply to pension plans such as the client.

We believe that because of our experience in working with these laws, and analogous ones in other states, we are better equipped to advise each of our clients regarding the options that they have in terms of the laws (and changes to those laws). By way of example, our clients in several states have recently been faced with new laws that require them to disclose significantly more detail as part of their FOIA obligations. We have advised these clients how to comply, while still maintaining access to attractive investment options.

EXHIBIT 1

About Us

At Reinhart Boerner Van Deuren, we know that every trusted relationship begins with understanding. That is why each of our committed attorneys take the time to listen critically, learn the unique attributes of each client's business, and work together to build a foundation for success that goes beyond providing legal services. While doing so, we draw upon an exceptionally broad base of experienced attorneys and a deep knowledge of the industries and sectors we serve. This blend of active understanding grounded by informed perspective equips our attorneys to deliver uniquely creative, yet efficient, legal counsel.

By consistently offering our clients cost-effective and innovative legal counsel, we have established ourselves as trusted advisors in many areas of corporate law. Our Client Service Standards, upheld to by all lawyers and staff, affirm our commitment to put the needs of our clients first and to pursue excellence in all that we do.

Reinhart Boerner Van Deuren meets the ever-evolving needs of today's business with innovation, focus and commitment. The firm's more than 200 attorneys are dedicated to providing accessible, responsive service from our seven offices throughout the country. Founded in 1894, Reinhart is one of the nation's 200 largest law firms (National Law Journal). We serve as attorneys and business law counselors to public and privately held corporations, financial institutions, family-owned businesses, retirement plans, exempt organizations and individuals. Throughout our history, we have relied on entrepreneurship, teamwork and dedicated service to help our clients achieve their business goals. Our client-driven approach is firmly rooted in creative thinking, intelligent advice and conscientious service, no matter what area of business law our clients require.

Service Standards

Reinhart Client Service Standards: Our Commitments; Your Assurances

Understand your business

We know our success depends on achieving cost-effective, practical results for our clients. Accordingly, we will make every effort to understand the business or personal circumstances that gave rise to the legal matters you bring us and to represent you and your interests as aggressively as we would our own. Protecting and advancing your best interests as a client is our most important service.

Understand your needs

At all times, we will seek to fully understand what your needs are, what you expect from us and when you expect it. If we feel that another service provider is in a better position to meet your needs or expectations, we will tell you and help you find the best resource for your needs.

Respond promptly to your communications

We will respond to your phone calls and e-mails as quickly as possible and no later than one business day after you contact us. However, every client has a different definition of “responsiveness.” Our lawyers and staff will go out of their way to understand how you define the term, and will then make every effort to meet or exceed your expectations.

Be accessible when needed

Our lawyers and staff check their voice mail and e-mail regularly, whether or not they are in the office. In addition, each lawyer’s secretary or assistant will know the whereabouts and schedule of that lawyer on any given day. When the attorney you are trying to reach is traveling, working outside the office or otherwise unavailable, the attorney’s secretary, assistant or another lawyer familiar with you and your needs will make every effort to assist you until such time as the lawyer can personally get back to you.

Set and meet deadlines toward the completion of your work

We will seek to understand your timetable for getting projects done, set specific deadlines for getting work back to you and then meet or beat those deadlines. If we ever feel that your timetable will compromise our ability to provide you with a quality work product, we will tell you and work with you to find a way to meet your needs.

Avoid surprises

Different clients have different information needs. At the outset of a matter, we will ask you the extent to which and how often you want to be kept informed. Thereafter, according to your wishes, we will keep you informed of your work-in-progress, send you copies of all relevant paperwork and notify you promptly of meaningful developments.

Respect your finances

We will strive to be efficient and cost effective in our delivery of services. We will:

- Promptly send you our bills
- Ensure our bills are clear and easy to understand
- Notify you promptly when we encounter or anticipate unexpected costs
- Resolve any billing questions or issues promptly and fairly

Staff your matters cost-effectively

Our objective in representing you is not to bill hours; rather, it is to help you resolve your legal-related business and personal matters as quickly, as successfully and as cost-effectively as possible. This may involve having different partners, associates, paralegals or staff within the firm work on your matters. We will, if you wish, discuss with you how we plan to staff your matter and why.

Welcome your ideas, your resources and your feedback

Since our success depends on your success, we welcome your ideas and suggestions. We also welcome any resources you can provide to help us resolve your legal matters as quickly and cost-effectively as possible, including in-house legal resources and any prior work product that will help us avoid a duplication of effort on your behalf. Most importantly, we want your feedback – positive or negative – because it is the only way that we can improve. We want you always to feel free to communicate your ideas, suggestions or dissatisfaction either to your primary attorney, to the firm’s managing partner or to the senior partner in the firm who we have designated as our “Client Satisfaction Advocate.”

Resolve your concerns

At Reinhart, we believe in the value of the legal work and the client service that we provide our clients. As a client of our firm – and the only person whose evaluation of our work matters to us – these Client Service Standards reflect our commitment to you to put your needs first.

If, at any time, you do not feel that the charges on a bill reflect the value you received, we invite you to contact your primary attorney or our Client Satisfaction Advocate, Larri Broomfield, at 414.298.8231. In any event, we will promptly resolve any concerns to your satisfaction. Your complete satisfaction and respect are the ultimate goals of our relationship.

EXHIBIT 2

OFFICERS

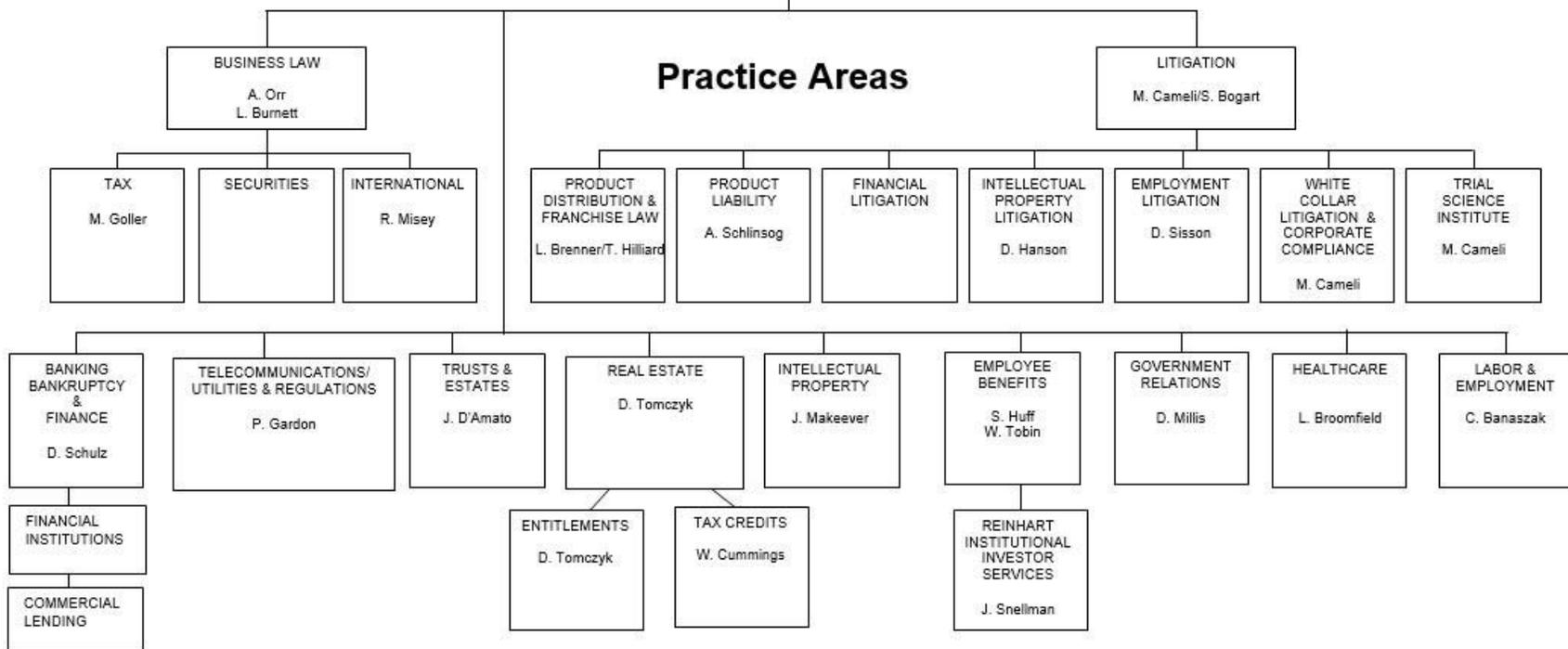
J. Janzer	Chairman, President/CEO & Director
A. Orr	Vice President & Director
W. Cummings	Vice President & Director
C. Banaszak	Vice President & Director
J. D'Amato	Vice President & Director
J. Mossberg	Vice President & Director
T. Reardon	Vice President & Director
S. Bogart	Vice President & General Counsel
J. Makeever	Special Vice President (Illinois)

BOARD OF DIRECTORS
 C. Banaszak
 W. Cummings
 J. D'Amato
 J. Janzer
 J. Mossberg
 A. Orr
 T. Reardon

CHIEF EXECUTIVE OFFICER
 J. Janzer



**Organizational Chart
 January 2019**



MILWAUKEE
 J. Janzer

MADISON
 L. Stathas
 (T. Reams)

WAUKESHA
 V. Beres
 (B. Lueck)

ROCKFORD
 J. Makeever
 (T. Billups)

CHICAGO
 J. Morrow

DENVER
 J. Culotti

PHOENIX
 W. Shroyer

Offices

EXHIBIT 3

Jussi P. Snellman

Shareholder
Madison

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Jussi P. Snellman is co-chair of RIIS. Jussi has advised dozens of pension clients in more than 1,000 investment transactions over the past 20 years. He devotes his practice to representing institutional investors in private market fund transactions, including private equity, real estate, venture capital and special situations, fund of funds and hedge funds, and negotiation of investment agreements. Also included in his practice is advising investors on other investment related matters, such as custody agreements, securities lending, investment management agreements, secondary sales of assets, manager transitions, compliance with public records laws and sovereign immunity, and workouts involving GP removal or replacements. Prior to joining Reinhart, Mr. Snellman represented private equity fund managers while at Kirkland & Ellis and Arnold & Porter in Denver and Washington, DC. He has been with Reinhart since 2005, and advising institutional investors since 1995.

Education

- J.D., University of Michigan Law School
- B.A., magna cum laude, Southern Methodist University; Phi Beta Kappa

Bar Admissions

- Colorado
- Texas
- Wisconsin

Practices

- Corporate Law
- Employee Benefits
- Institutional Investor Services

Affiliations

- State Bar of Wisconsin
- State Bar of Texas
- American Bar Association
- National Association of Public Pension Attorneys

Matters

Jussi is a member of Reinhart's Institutional Investor Services (RIIS) group, and advises pension funds and other institutional investors in connection with private equity investments, hedge fund investments and implementation of fiduciary responsibilities in regard to alternative investments. Reinhart represents 11 of the 50 largest pension plans in the world.

Social

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Andrew O. Christianson

Shareholder
Waukesha

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Andrew O. Christianson is a shareholder in the firm's Employee Benefits, Institutional Investor Services, Corporate Law and Securities practices. Andy is a trusted adviser to domestic and non-U.S. governmental pension plans, insurance companies and other institutional investors in structuring and negotiating private equity, hedge fund and alternative investments. He also represents public and closely held companies on a range of transactional and compliance matters, including securities compliance, corporate governance, M&A and other corporate transactions. Andy primarily serves the following industries:

- Institutional Investor Services
- Securities
- Corporate Governance
- Mergers and Acquisitions
- Private Equity

Andy practiced for several years with a global, publicly traded specialty chemical company. During his time in-house, he worked closely with a team of executive officers and senior management and was responsible for securities filings, compliance, investor relations, M&A and other corporate transactions. Andy advised the board of directors and its committees on various corporate governance, compliance, executive compensation and corporate secretarial matters. He also supported a wide variety of internal functions in corporate and compliance matters, including the accounting, tax, benefits and treasury departments.

Andy's broad range of experiences and unique perspective having worked both in private practice and for a publicly traded company provides clients with unparalleled service informed by multiple vantage points.

Education

J.D., cum laude, University of Wisconsin Law School
B.B.A. in Finance, Investments, and Banking, University of Wisconsin-Madison

Bar Admissions

Wisconsin

Practices

- Employee Benefits
- Institutional Investor Services
- Corporate Law

Specialty Practices

- Securities

Social

LinkedIn (<https://www.linkedin.com/in/andrew-christianson-a119835/>)

Matters

- Reviews and negotiates legal documents in connection with investments in private market investments.
- Works with public companies on a range of compliance matters under SEC and state securities laws and regulations.

Honors & Affiliations

- State Bar of Wisconsin
- National Association of Public Pension Attorneys
- Society of Corporate Secretaries & Governance Professionals

Stacie M. Kalmer

Shareholder
Milwaukee

Office: 414.298.8220

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Stacie Kalmer is a shareholder in Reinhart's Employee Benefits Practice counseling a wide variety of multiemployer, corporate and governmental plan clients on an array of employee benefit plan issues. She advises clients on plan design and administration and also advises plan fiduciaries on fiduciary compliance and corporate governance issues under federal and state law.

Stacie has considerable experience with the Affordable Care Act, and her breadth of knowledge regarding this topic is a great asset to clients. Outside of the office, Stacie is a frequent presenter on topics surrounding the challenges associated with the Affordable Care Act and ever-evolving legislative developments.

Stacie primarily serves the following industries:

- Qualified Retirement Plans
- Health Plans
- Employee Benefits Plans in Mergers and Acquisitions
- Taft-Hartley Multiemployer
- Affordable Care Act

Education

J.D., magna cum laude, Marquette University Law School
B.A., University of Wisconsin-Madison (Political Science)

Bar Admissions

Wisconsin

Practices

- Employee Benefits
- Institutional Investor Services

Specialty Practices

- Corporate Benefits
- Taft-Hartley

Services

- Affordable Care Act
- Employee Benefits Plans in Mergers and Acquisitions
- Health Plans
- Qualified Retirement Plans

Matters

- Advises public pension plan clients on fiduciary duty matters
- Advises clients on Health Care Reform compliance and planning
- Drafting summary plan descriptions of health plans and other health plan documents
- Conducting employee benefits due diligence as a part of corporate transactions
- Advising multiemployer plans and corporate clients on issues relating to qualified domestic relations orders (QDROS)
- Consulting on retirement and welfare plan design issues
- Preparing IRS determination letter filings and correction program filings

Honors & Affiliations

- Wisconsin Bar Association
- Milwaukee Bar Association
- Marquette Law Review (Articles editor)
- The Greater Milwaukee Employer Benefits Council (GMEBC)
- Wisconsin Retirement Plan Professionals, Ltd (WRPPL)

Presentations

- “Advanced Issues and Negotiations with Health Care Providers,” 2018 Annual Conference, International Foundation of Employee Benefit Plans
- “ACA Reporting Obligations for Participating Employers,” 2015 Michigan United Food and Commercial Workers Unions and Employers Health and Welfare Plan
- “ACA Compliance for Affiliated and Related Employers,” 2015 Milwaukee Bar Association
- “Navigating the ACA When You Have Union and Non-Union Employees,” 2014 Wisconsin Chapter of the National Electrical Contractors Association, Associated General Contractors of Wisconsin and

AGC of Michigan

- “Health Cost Budgeting Challenges for 2014,” 2014 MRA
- “The Fall of DOMA: Impact of US v Windsor and Health Care Reform: Looking Ahead to 2014,” 2013 Society for Human Resource Management
- “Health Care Reform: Looking Ahead to 2014,” 2013 Ozaukee Bar Association
- “Health Care Reform: 2012 Update,” 2012 Milwaukee Bar Association

Jessica P. Culotti

Shareholder
Milwaukee, Denver

Office: 414.298.8204
Office 2: 303.843.6042

jculotti@reinhartlaw.com



Jessica P. Culotti is a shareholder in Reinhart's Employee Benefits Practice where she advises government employers, corporate clients and Taft-Hartley funds in all areas of employee benefits, including plan administration, fiduciary obligations and compliance with the Internal Revenue Code, ERISA and other applicable federal and state laws.

Education

J.D., magna cum laude, University of Wisconsin Law School; Order of the Coif
B.A., University of Minnesota (Journalism and Strategic Communications)

Bar Admissions

Wisconsin
Minnesota
Colorado

Practices

- Employee Benefits
- Institutional Investor Services
- Tax-Exempt Organizations

Specialty Practices

- Corporate Benefits
- Taft-Hartley

Social

LinkedIn (<https://www.linkedin.com/pub/jessica-culotti/13/46/6a7>)

Matters

- Advises multiple public retirement funds, single employer and Taft-Hartley funds on plan qualification, benefit administration and fiduciary responsibility
- Represents clients in negotiations with and audits from the Internal Revenue Service (IRS) and Department of Labor (DOL)
- Assists clients with identification and correction of plan errors under the IRS's Employee Plans Compliance Resolution System
- Negotiates service provider contracts with service providers including actuaries, pharmacy benefit managers, managed medical review organizations and investment consultants
- Counsels Taft-Hartley, single-employer clients and government plans on issues related to Qualified Domestic Relations Orders (QDROs)

Honors & Affiliations

- Wisconsin Humane Society (Young Leaders Advisory Board)
- Association for Women Lawyers
- Wisconsin Bar Association
- Milwaukee Bar Association
- National Association of Public Pension Attorneys (NAPPA)

Presentations

- "Legal Update on ACA and DOMA," Sheboygan Area SHRM (November 21, 2013)
- "U.S. v. Windsor: Fall of DOMA and Impact on Employee Benefit Plans," Metro Milwaukee SHRM Legislative Group (October 17, 2013)
- "HIPAA: Questions Answered; DOMA: Questions Raised," Milwaukee Bar Association (September 13, 2013)

Nicholas W. Zuiker

Associate
Milwaukee

Office: 414.298.8366

nzuiker@reinhartlaw.com



Nicholas W. Zuiker is an attorney in Reinhart’s Employee Benefits Practice. Nick focuses his practice on advising institutional clients, including U.S. and non-U.S. pension plans, insurance companies and similar institutional investors, in connection with alternative investments. He regularly negotiates favorable legal terms and side letter provisions on behalf of institutional investor clients, and also advises on a range of fiduciary compliance matters and governance and legislative issues. Nick also advises ESOP-owned companies and fiduciaries on a variety of transactional and compliance matters associated with the buying and selling of ESOP-owned companies, and on various ESOP design and compliance issues.

Nick primarily serves the following industries:

- Institutional Investor Services
- Employee Stock Ownership Plans
- Qualified Retirement Plans
- Taft-Hartley Multiemployer Plans

Education

J.D., cum laude, University of Wisconsin Law School (Order of the Coif)
B.A., summa cum laude, University of Minnesota

Bar Admissions

Wisconsin

Practices

- Employee Benefits
- Institutional Investor Services



Services

- Employee Stock Ownership Plans
- Qualified Retirement Plans

Honors & Affiliations

- *Wisconsin Journal of Law, Gender and Society* (former Submissions Editor)

EXHIBIT 4



***Illinois State Board of Investment
Fiduciary Training
December 17, 2009***

Keith Johnson

Reinhart Boerner Van Deuren

Emily Reid

ISBI General Counsel



Fiduciary Duty Overview

- Trustee legal obligations require
 - Loyalty to interests of participants
 - Prudence of an investment expert
 - Diversification of investments
 - must be reasonable and appropriate
 - Compliance with Illinois Pension Code

“A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.” Justice Cardozo, NY Supreme Court (1928)



Recent Legislative Changes

- Legislation enacted earlier this year
- Created mandate for eight hours of Trustee training annually
 - Ethics
 - Fiduciary duty
 - Investment issues
 - Pension fund administration

Pension Code § 1-113.18

Key Concepts

- Trust fund assets are not State monies
- Trustees represent all fund participants
 - Favoritism to constituencies is prohibited
 - Duty of impartiality
- Public pension trustees highly scrutinized
- Standards higher than for corporate directors
- No such thing as a “Prudent Klutz”
 - Having a “pure heart and an empty head” is not sufficient
 - Donovan v. Cunningham, 716 F.2d 1455, 1467 (5th Cir. 1983).

"Perhaps the most important function of a pension board is to ensure adequate financial resources to cover the Board's obligations to pay current and future retirement and disability benefits to those who qualify for such payments." Marconi v. Chicago Heights Police Pension Bd., 870 N.E.2d 273, 320 (Ill. 2007).

Sources of Guidance

- Illinois Pension Code
- Court decisions and common law of trusts
- ERISA and other pension fund laws
 - ISBI standard of prudence tracks ERISA
- Model codes
- Restatement of Trusts
- Practices of other similar fiduciaries
- Attorney General Opinions
- Advice of legal counsel

"Given the lack of Illinois caselaw construing the ... Pension Code, [courts] look for guidance to analogous provisions of the Employee Retirement Income Security Act of 1974 (29 U.S.C. §1001 et seq. (1988)) ("ERISA"), and the federal caselaw construing ERISA." Bd. of Trustees of the Vill. of Barrington Police Pension Fund v. the Ill. Dept. of Ins., 570 N.E.2d 622, 629 (Ill. App. 1st Dist. 1991).



CFA Code Recommendations

- Act in the best interest of participants
 - With prudence & reasonable care
 - With skill, competence & diligence
- Avoid self-dealing & conflicts of interest
- Refuse unauthorized gifts or benefits
- Follow laws, rules & plan requirements
- Deal fairly & impartially with all participants
- Regularly review performance & success
- Honor confidentiality
- Communicate with participants & authorities

Who is a Fiduciary?

- Anyone who exercises authority or control over pension fund management or administration
- Those designated by statute
- Outside service providers that accept fiduciary duties by contract
- ISBI fiduciaries include Trustees, senior staff, investment managers, investment advisors and investment consultants

"Members are clearly fiduciaries under the express terms of the [Illinois Pension Code]... Moreover, because of the express powers and duties conferred on such Members by the Code, the Members would appear to qualify as fiduciaries under the general law of equity." Ill. Att'y Gen. Op. No. 059, p. 3 (1982).



Duty of Loyalty

- A fiduciary “shall” discharge his or her duties “solely in the interest of the participants and beneficiaries and for the exclusive purpose of (1) providing benefits to participants and their beneficiaries; and (2) defraying reasonable expenses of administering the retirement system or pension fund.”

40 ILCS § 5/1-109

Duty of Loyalty

- Exclusive benefit of participants
- Ethics Code compliance
- Avoid self-dealing
- Attend to conflicts of interest
- Cannot play favorites
- Even the appearance of impropriety can affect public perceptions & cause damage
- Illinois statutory requirements

*A trustee's fiduciary duty "is owed to all participants in the pension fund."
Marconi, 870 N.E.2d at 320.*

Ethical Standards

- Conflicts of interest, independence & loyalty
- Higher expectations than in private sector
- Application to family members
- Limits on soliciting or receiving gifts & gratuities
 - Prohibited sources
 - Broad definition of “gift”
 - Exemptions
- Personal investments and prohibited transactions
 - Prohibited transactions
 - Self-dealing and “other-dealing”
 - New provisions
- Statements of Economic Interests
- Recusal from Board deliberations if conflicted

Additional Requirements

- Prohibited political activities
 - Offers in exchange for contributions
- Employee whistleblower protections
- Ex parte communications
 - Obligation to share relevant information
- Approval of Trustee travel by Board
- Revolving door restrictions after leaving
- Obtaining advice and guidance

The Whistleblower Section of the State Officials and Employees Ethics Act allows for individual officials and employees to be held liable for violations of the Act, and allows claimants to recover punitive damages in order to prevent future violations. Maes v. Folberg, 504 F.Supp.2d 339, 350 (N.D.Ill. 2007), on reconsideration in part 531 F. Supp.2d 956, 957 (N.D.Ill. 2007).

Duty of Loyalty Danger Zone

- Rewarding friends or supporters
- Accepting gifts, free tickets or gratuities
- Offers of special deals or price breaks
- Failure to identify and neutralize conflicts
- Investments to serve other interests
 - Economically or politically targeted investments
- Deferring costs/risks to future participants
- Bending the rules
- Failure to monitor ethical compliance
- Expecting staff to police fiduciary breaches

Fiduciary Failures?

NEWS
N.H. Pension Chair Fights
Ouster Over Ethics
FUNDfire (August 4, 2005)

NEWS
Detroit Pension Trustees Travel
Globe as Funds Lose Billions
Detroit Free Press (May 5, 2009)

"In the last 14 months, lawyers and others tied to 51 firms interested in representing the SBA have spent at least \$850,000 on Florida politics."
St. Petersburg Times (December 12, 2009)

"A sweeping investigation into bribery for investment contracts at the state insurance fund for injured workers has expanded to now include Ohio's pension funds and the State Treasury."
Associated Press (June 16, 2006)

NEWS
Pension Board Member Directed
Funds to a Firm With Ties to His,
Documents Show
Los Angeles Times (Nov. 20, 2009)

NEWS
Pension Board Violates
Open Meeting Law; Again
The Eagle Tribune
(August 26, 2009)



Duty of Prudence

- A fiduciary “shall” discharge his or her duties “solely in the interest of participants and beneficiaries and with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”

40 ILCS §5/1-109 [Follows ERISA standard of care]



Prudent Expert Standard

- Process oriented, with focus on diligence
- Deference to accepted industry practices
- Decisions evaluated in context of total portfolio
 - Protection from hindsight bias
- Trustees must use any special personal skills
- Encourages reliance on qualified experts
 - Experts should be questioned to ensure reliability
 - Second opinions can give comfort if controversial
- Goal is total net return over the long term



Diversification

- Trustees “shall” discharge duties “by diversifying the investments of the retirement system or pension fund so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.” 40 ILCS § 5/1-109
- Asset allocation is a key responsibility
 - Advice from qualified experts required
 - Goal is net return over the long-term



Delegation of Authority

- Board may delegate to qualified staff and investment advisors
 - Selection, instruction and monitoring required
 - Proper delegation transfers responsibility
 - Costs must be reasonable and appropriate
- Competitive selection process mandated
- Key staff hiring & job descriptions important
- Written policies and guidelines
 - Board policymaking v. staff administration roles
- Regular reporting and evaluation

Co-Fiduciary Liability

- “Each trustee shall use reasonable care to prevent any other trustee from committing a breach of duty.” 40 ILCS § 5/1-109.2
- All Trustees retain joint responsibility for Board’s duties
 - Fiduciaries cannot avoid responsibility by looking the other way
 - Ethics and other duty of loyalty breaches are the biggest co-fiduciary liability risks
 - Clear guidelines and compliance monitoring important

"Where certain members of the Board insist on making an investment which from the outset is clearly not prudent, subsection 1-109.2(b)(1) mandates that the other members 'use reasonable care to prevent' the others from breaching their fiduciary duty." Ill. Att'y Gen. Op. No. 059, p. 11.

Cost Management

- Duty of loyalty requires that costs and expenses be reasonable and appropriate
 - Must relate to providing participant benefits
 - Comparisons made to other similar investors
 - Consider net long-term returns after expenses
- Cannot expend trust funds to achieve unrelated social or policy goals
 - Identification, evaluation & management of long-term investment-related risks & opportunities is proper
- Implicit/hidden investment costs must be reasonable
 - Seek best net execution on transactions
- Spending too little can also cause problems

"Entering into an agreement for services, including investment services, without meaningful information regarding the cost and value of such services, would not meet the prudent man standard, and would be arbitrary and capricious." Ill. Att'y Gen. Op. No. 30, p. 12 (1996).



Other Statutory Obligations

- Prohibited Fund investments
- Placement fees precluded
- Proxy voting
 - Shares must be voted in participants' interests
- Transparency and reporting
- Valuation of assets
- Open Meetings Law
- Freedom of Information Act / Open Records

Liability

- Personal liability
- Indemnification
 - Willful misconduct/gross negligence exception
- Sovereign Immunity
 - Statutory authorization needed to sue State
 - Illinois Court of Claims procedure
- Fiduciary insurance
- Representation by Attorney General
 - Criminal/intentional misconduct excluded

"The members of the Board have significant powers and perform significant duties. Consequently, if sued in their official capacity, the Board members may be represented by the Attorney General...[W]here an officer or employee is sued personally for breach of fiduciary duty, it is unlikely in any case, that it would be proper for the Attorney General to represent that officer." Ill. Att'y Gen. Op. No. 059, p. 15.



Avoiding Liability

- Trustee education and training
- Emphasize ethics code and conflicts compliance
- Select competent staff and advisors
- Adopt policies and guidelines
- Identify and manage risks
- Elicit input from your staff and experts
- Monitor/evaluate those with delegated duties
- Review/address audit findings
- Conduct board self-evaluations
- Strive to identify and adopt best practices



Seven Deadly Sins of Trustees

- Apathy
- Cowardice
- Laziness
- Ignorance
- Excessive self-reliance
- Self enrichment (socially or financially)
- Deception

Best Governance Practices

- Best governance practices can add 1 – 2% annual return
 - Compliance with fiduciary duty is merely a baseline goal
- Annual Board evaluations & Trustee skill improvement plans
 - Develop a “culture of continuous improvement”
- State and understand the Board’s mission
- Maintain separation of Board and staff roles
- Neutralize externally-imposed, conflicting mandates
- Collaborate with similar funds where shared goals
 - Cuts costs and improves effectiveness
- Pay staff at competitive market levels
 - Maintains access to non-conflicted internal expertise

Source: “Making Pension Boards Work: The Critical Role of Leadership”
International Journal of Pension Management, Vol. 1, No. 1, 2008



Other Fund Responsibilities

- Similar fiduciary standards apply to other ISBI funds
- Deferred compensation plan
 - Selection of investment options
 - Monitoring, evaluating and reporting
 - Expense management
 - Diversification
 - Proxy voting
 - Participant education
 - Measuring success
 - Respond with improvement plans



Questions?

EXHIBIT 5

Introduction to Institutional Investor Fiduciary Duties

Keith L. Johnson
Chair of Institutional Investor Services Group
Reinhart Boerner Van Deuren s.c.

February 2014

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International Institute for Sustainable Development

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IISD's vision is better living for all—sustainably; its mission is to champion innovation, enabling societies to live sustainably. IISD is registered as a charitable organization in Canada and has 501(c)(3) status in the United States. IISD receives core operating support from the Government of Canada, provided through the International Development Research Centre (IDRC), from the Danish Ministry of Foreign Affairs and from the Province of Manitoba. The Institute receives project funding from numerous governments inside and outside Canada, United Nations agencies, foundations and the private sector.

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Introduction to Institutional Investor Fiduciary Duties

January 2014

Written by Keith L. Johnson, Chair of Institutional Investor Services Group, Reinhart Boerner Van Deuren s.c.

Keith L. Johnson chairs the Institutional Investor Services Group at Reinhart Boerner Van Deuren s.c., a Midwest-based law firm in the United States. Johnson represents pension funds and institutional investors globally on fiduciary, investment, corporate governance and securities litigation matters. He is currently Co-Chair of the Fiduciary Duty Working Group at the Network for Sustainable Financial Markets, an international think-tank, and is a member of the International Corporate Governance Network's Shareholder Responsibilities Committee. Johnson is also a member of the Wisconsin Bar Association, Texas State Bar and American College of Investment Counsel.

Before joining Reinhart, Johnson served for 21 years as legal counsel to the State of Wisconsin Investment Board (SWIB). He was on the Executive Board of the National Association of Public Pension Attorneys (NAPPA) and was President of the organization, as well as Co-Chair of the NAPPA Securities Litigation Task Force, Alternative Investments Working Group and Section on Investment and Corporate Governance.

Table of Contents

Introduction	1
1.0 The International and Historical Origins of Fiduciary Duties.....	2
2.0 Fiduciary Duties Protect Vulnerable Beneficiaries.....	3
3.0 Governance of Fiduciaries.....	5
4.0 Ongoing Evolution of Fiduciary Duty	7
5.0 Environmental and Climate Risk Factors as an Emergent Fiduciary Issue	8
6.0 Model Fiduciary Practices	11
South Africa.....	11
United States.....	12
The Netherlands	14
Norway.....	14
7.0 Summary	17
8.0 Next Steps.....	19
References.....	20

Introduction

Fiduciary relationships involve the delegation of authority to an agent who is charged with investing assets for the benefit of third-party beneficiaries. However, the beneficiaries rarely possess both the information and expertise to evaluate the integrity and effectiveness of the agent's management services in a timely way, even though the beneficiaries are forced to rely on them. Fiduciary duties are the legal principles that protect beneficiaries and society from being taken advantage of by these fiduciary agents. While local culture and legal structures influence how fiduciary principles are expressed, due care in managing the assets and dedication to serving beneficiaries' interests are key to this relationship of trust (Richardson, 2011).

The practices used to implement these fiduciary principles typically evolve over time in response to changing circumstances and knowledge. Given the changes that have occurred in the global economy over the past 40 years, including responsibility for greater amounts of assets being delegated to fiduciary agents, increased resource constraints from rising populations and growing prosperity and soaring costs from the effects of pollution and climate change, fiduciary standards are once again in flux. Because environmental issues and climate risk are global matters which cross national borders, have financial implications and involve fiduciary issues of intergenerational fairness, they have become a major focus of the current international evolution in fiduciary thinking.

This paper explores the importance of guiding legal principles in protecting beneficiaries and society from abuse of delegated investment powers by fiduciary agents. It argues that countries that can most effectively navigate the transition to modern and sustainable fiduciary investment practices will be able to allocate capital more efficiently, reduce the negative side effects of investment practices and have a long-term competitive advantage in the 21st century. Given the growing economic significance of China's pension funds, the National Social Security Fund and other assets managed by delegated agents on behalf of third-party beneficiaries, this could be an opportune time to establish culturally appropriate fiduciary principles for China. Pension funds in South Africa, the Netherlands, Norway and the United States offer models for the People's Republic of China (PRC) to consider in planning its transition to fiduciary standards and investment practices that support sustainable development.

"To ignore the risks around climate and sustainability in your portfolio could be and will be characterized as a dereliction of your fiduciary duties."

*Kevin Parker, former Global Head,
Deutsche Asset Management*

1.0 *The International and Historical Origins of Fiduciary Duties*

While the proliferation and complexity of investment fiduciary relationships is a relatively recent phenomenon from the 20th century, the basic concepts of fiduciary duty are ancient. In fact, the English word “fiduciary” has its roots in the Latin word “fiducia,” which means both “trust” and “confidence.”¹

Today’s fiduciary duties have historical roots in China that can be traced back to Confucius (whose questions of self-examination included whether, when acting on behalf of others, one has always been loyal to their interests) and to the Great Qing Legal Code (where criminal punishment was provided for one who receives deposit of property of another and consumes it without authority) (Aikin & Fausti, 2010–2011). Outside of China, historians attribute the origins of fiduciary concepts to the Code of Hammurabi (~1790 BC) in Babylon on the role of agents entrusted with property, medieval English trust law, 5th century Islamic laws on family and charity and 4th century Roman efforts to avoid legal restrictions on inheritance (Aikin & Fausti, 2010–2011; Avini, 1996). Those early fiduciary arrangements typically involved transferring the ownership of assets to a third-party agent who would manage the assets to achieve specific wishes of the grantor, for example, to take care of family members, pursue charitable purposes or hold it for the benefit of someone else where necessary to avoid legal restrictions on the transfer of property (Avini, 1996).

Today, investment fiduciary relationships also involve delegation to an agent of discretionary management responsibility for particular assets in order to provide future benefits to one or more third-party beneficiaries or specified purposes. Such relationships are based on a high level of trust and confidence in the agent. Fiduciary duties supply rules which guide the agent’s implementation of those delegated responsibilities, with the goal of ensuring that the fiduciary faithfully fulfills its obligations (Sarro & Waitzer, 2012). However, there is no universal definition of fiduciary duty. Concepts of fiduciary duty cross the boundaries of different fact situations, legal systems and cultures, making a single global definition impossible (Krikorian, 1989).

“Failure to consider climate change risk as either part of risk management, or in an investment strategy, in the context of the legislation in Australia, may constitute a breach of trustees’ duties.”

Baker & McKenzie Law Firm

¹ “Fiducia.” Def. Latin Word List. <http://www.latinwordlist.com/latin-words/fiducia-10914362.htm>

2.0 *Fiduciary Duties Protect Vulnerable Beneficiaries*

Despite the local distinctions that create nuances of fiduciary duty in each jurisdiction, there are common dynamics at play in investment fiduciary relationships, regardless of the culture or jurisdiction. These issues must be resolved in some manner, whether intentionally or by default. The primary challenge is that investment fiduciary relationships typically leave beneficiaries and society vulnerable to abuse at the hands of the fiduciary (Sarro and Waitzer, 2012). For example:

- The fiduciary is given control over management of assets that must be deployed for the benefit of others, creating an inherent conflict of interest.
- Fiduciaries usually possess specialized expertise that the beneficiaries do not have, making the quality of services hard to evaluate.
- Breaches of faithfulness or investment prudence might not be immediately evident, which impedes effective monitoring of the fiduciary.
- Unlike investors in tradable company securities, beneficiaries often do not have the practical ability to avoid harm by removing a fiduciary or timely withdrawing assets from the fund.
- Workers are likely to be heavily reliant upon pension funds and other fiduciary savings vehicles for their future security, creating both personal and broader economic risks.
- In many countries, growth in the amount of assets controlled by institutional investor fiduciaries has turned them into a formidable economic force with societal ramifications.
- Fiduciaries may have more to gain than lose personally by generating near-term performance through externalization of costs and risks to society, especially when damage is not immediately apparent.

Given these vulnerabilities, it is evident why fiduciary relationships are based on trust and confidence. Fiduciary duties are intended to supply the standards needed to protect beneficiaries and society from being taken advantage of in fiduciary relationships. However, fiduciary duties arise within the context of local culture, legal systems, authorizing statutes, regulations, practice codes and court decisions.

Even though fiduciary standards may vary in how they are applied between jurisdictions, there are consistent themes. Table 1 provides a representative list of common law fiduciary duties and civil law principles that guide the governance and investment practices of institutional investment fiduciaries across the globe (Freshfields Bruckhaus Deringer 2005; 2009). Fiduciary duties focus on process and behavior, rather than investment outcomes. Despite variations in wording, fiduciary principles in most jurisdictions address:

- Loyalty, including faithfulness to the interests of beneficiaries and purpose of the fund and impartiality when taking different interests of beneficiaries into account.
- Prudence and care in managing investments, diversification and risks.
- Control of costs and management of conflicts of interest.
- Transparency and accountability.
- Compliance with terms of the operative documents and applicable laws.

BOX 1 SAMPLE FIDUCIARY DUTY PRINCIPLES

COMMON LAW FIDUCIARY STANDARDS

Restatement of Trusts (Duty of Prudence)

- (1) The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust.
 - a. This standard requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.
 - b. In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.
 - c. In addition, the trustee must:
 - i. Conform to fundamental fiduciary duties of loyalty and impartiality
 - ii. Act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents; and
 - iii. Incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship.

Restatement of Trusts (Duty of Loyalty)

- (1) Except as otherwise provided in the terms of the trust, a trustee has a duty to administer the trust solely in the interest of the beneficiaries, or solely in furtherance of its charitable purpose.
- (2) Except in discrete circumstances, the trustee is strictly prohibited from engaging in transactions that involve self-dealing or that otherwise involve or create a conflict between the trustee's fiduciary duties and personal interests.
- (3) Whether acting in a fiduciary or personal capacity, a trustee has a duty in dealing with a beneficiary to deal fairly and to communicate to the beneficiary all material facts the trustee knows or should know in connection with the matter.

Restatement of Trusts (Duty of Impartiality)

- (1) A trustee has a duty to administer the trust in a manner that is impartial with respect to the various beneficiaries of the trust, requiring that:
 - a. In investing, protecting, and distributing the trust estate, and in other administrative functions, the trustee must act impartially and with due regard for the diverse beneficial interests created by the terms of the trust; and
 - b. In consulting and otherwise communicating with beneficiaries, the trustee must proceed in a manner that fairly reflects the diversity of their concerns and beneficial interests.

Employees Retirement Income Security Act (Standard of Care; Sole Purpose)

- (1) A fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and
 - a. For the exclusive purpose of:
 - i. Providing benefits to participants and the beneficiaries; and
 - ii. Defraying reasonable expenses of administering the plan;
 - b. With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
 - c. By diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
 - d. In accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of the Act.

CIVIL LAW STANDARDS

Germany

The [...] capital of pension funds has to be invested in a way which guarantees the highest possible security and profitability, a sufficient liquidity and an adequate spread of risks.

The pension fund has to inform the beneficiaries in writing if and how it takes ethical, social and ecological aspects into account in its investment policies. [Investments] are to be managed professionally in particular by putting in place adequate systems to control risk, efficient in-house investment principles and control mechanisms, a sound investment policy and other organizations safeguards.

Japan

Administrative officers of the fund are obliged to obey the law and regulations, decisions of the Minister of Health, Labor and Welfare pursuant to the law and the investment principles established by the fund and must perform their duties with regard to the management and administration of the fund faithfully on behalf of the fund.

Operation of the fund must be carried out in a prudent and effective manner in accordance with applicable governmental orders.

Source: Freshfields Bruckhaus Deringer 2005 and 2009

3.0 Governance of Fiduciaries

Within the context of these guiding fiduciary principles, there are differences between jurisdictions in institutional investor structures and how fiduciaries function. For example, common law jurisdictions tend to operationalize fiduciary relationships through trusts and provide greater interpretive discretion to judges, while civil law countries are likely to use a contractual arrangement with a financial institution or management company and focus more on specific regulatory guidance than principles (Stewart & Yermo, 2008).

However, there are a growing number of exceptions to this traditional divergence. In the United States, insurance companies sell annuities and other pension products under a contractual structure, without accepting trust law fiduciary responsibilities. Even in the UK, investment managers hired by pension boards to manage assets are treated as contractors and not considered fiduciaries, unless bound as such by contract (Freshfields Bruckhaus Deringer, 2005; Berry, 2011). Conversely, by one count, over 40 civil law jurisdictions (including the PRC) have explicitly adopted common law trust statutes and related fiduciary duties for some purposes (Honoré, 2008).

Table 2 illustrates how fiduciary duty flows through common law and civil law systems. While the structures and operational systems can be very similar, they can also be quite complex. As noted above, different entities even in the same jurisdiction can fall under different regulatory and legal systems. For instance, insurance companies and mutual funds might be seen as contractors while pension funds and sovereign wealth funds are trust fiduciaries. Regardless of the category (civil law, common law, contract or trust), governance and investment practices are available for implementation to protect beneficiaries and society from fiduciary misconduct or irresponsibility (Honoré, 2008; de Graaf & Johnson, 2009).

Indeed, governance and implementation practices of institutions that function as investment fiduciaries are essential aspects of fulfilling fiduciary duties. Fiduciary responsibility and fiduciary governance are opposite sides of the same coin. Fiduciary duties are of no avail if they are not understood and implemented appropriately (Weng, 2011). Transparency and enforcement are particularly essential for an effective fiduciary structure.

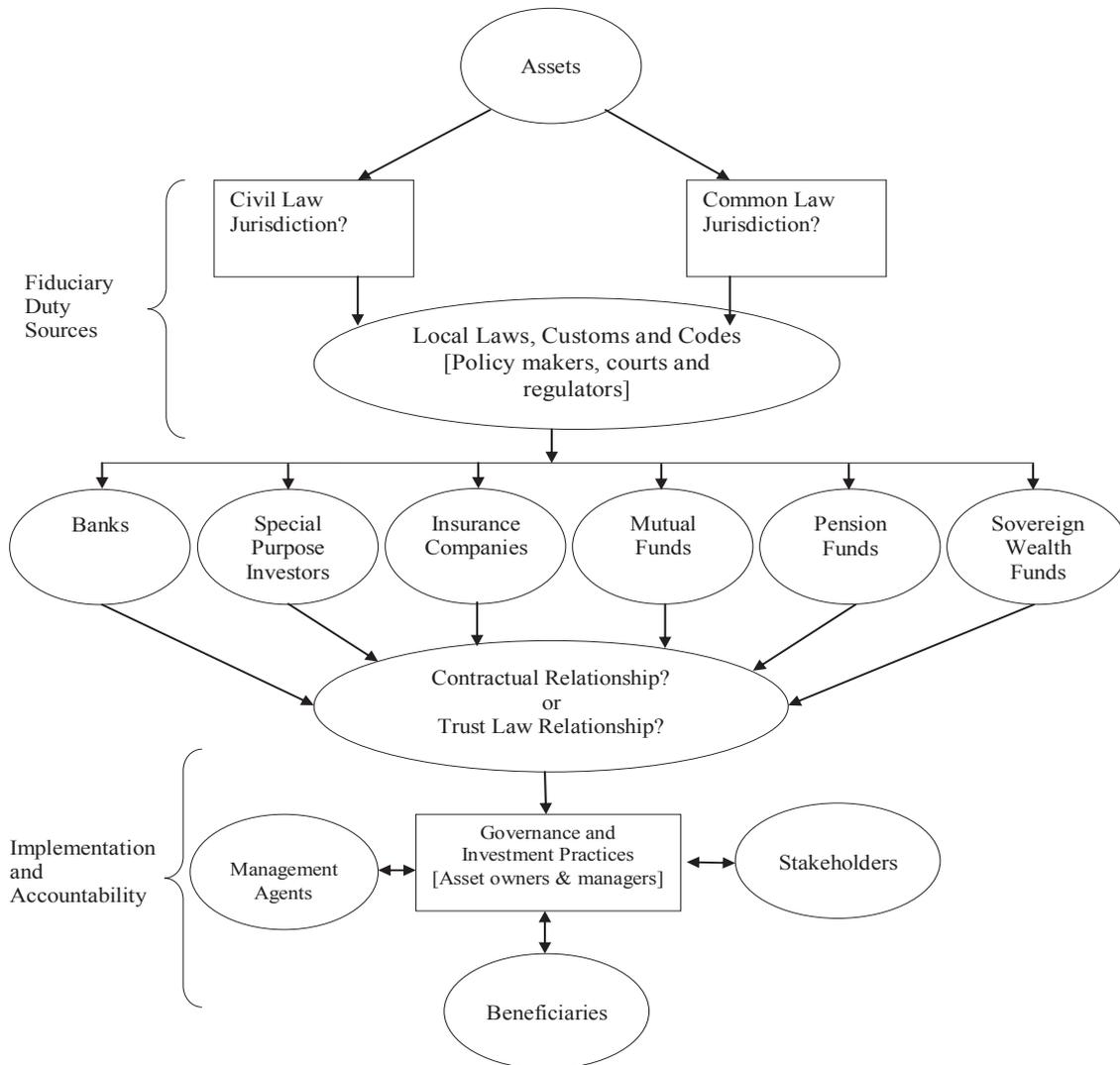


FIGURE 1. FIDUCIARY DUTY AND GOVERNANCE FLOW CHART

“Circumstances change. An investment considered prudent in earlier times may rightfully be regarded as quite imprudent in the context of modern conditions.”
Estate Richards v Nichol, South Africa (1999)

4.0 Ongoing Evolution of Fiduciary Duty

Fiduciary relationships have ancient roots, but understanding and implementation of fiduciary duties are dynamic. Fiduciary norms regularly evolve in response to changes in society, the economy and knowledge.

Following the collapse of the South Sea Bubble in the early 18th century, English courts required trustees to limit investments to government debt and securitized mortgages. As circumstances changed, American courts loosened investment restrictions and expanded allowable investments to those that would be purchased by a prudent man in managing his own affairs. The tables turned again in 1869, when American courts and legislatures excluded corporate stock and reverted to a more conservative legal list of allowable investments. In the 1970s and 1980s, common law jurisdictions transitioned to Modern Portfolio Theory (MPT) as the controlling concept for investment fiduciaries, looking at investment risk on a portfolio (rather than individual investment) basis. At the end of the 20th century, reference to practices of similar prudent expert investment fiduciaries and use of MPT were firmly established as the operative fiduciary standards (Hawley, Johnson, and Waitzer, 2011).

However, changes in the markets and risk environment have again brought many jurisdictions to a point where understanding of fiduciary duty has begun to change. A number of factors are driving this current fiduciary duty evolutionary cycle (Hawley, Johnson, and Waitzer, 2011). Among them are:

- Worldwide growth of the assets managed by institutional fiduciaries and corresponding influence on the economy.
- A series of economic crises of increasing severity.
- Demonstrated unreliability of assumptions underlying MPT.
- Emergence of climate change as a threat to long-term economic stability.
- Recognition that environmental pollution has become a drag on economic productivity.
- Global population increases, rising consumer demands from improved living standards in emerging markets and impending natural resource shortages.

5.0 Environmental and Climate Risk Factors as an Emergent Fiduciary Issue

The United Nations Principles for Responsible Investment (UNPRI) and United Nations Environment Program Finance Initiative (UNEP-FI) warned in 2010 that “Trends such as climate change, water scarcity, air pollution, biodiversity loss and ecosystem degradation all continue to threaten our finite stock of natural capital and the ability of our economy to provide sustainable growth and prosperity for all” (UNPRI & UNEP-FI, 2010, p.1). Table 3 summarizes the growing environmental costs for the global economy. These environmental costs also pose financial risks to portfolios and to economic growth. For example, health-related costs of air pollution alone were estimated at six percent of China’s GDP in the mid-2000s (Hill, 2013). In addition, annual costs of environmental degradation in the PRC have been estimated at nearly 10 percent of GDP (World Bank, 2013).

TABLE 1 ANNUAL ENVIRONMENTAL COSTS FOR THE GLOBAL ECONOMY IN 2008 AND PROJECTIONS FOR 2050

ENVIRONMENTAL IMPACT	EXTERNAL COSTS IN 2008 (US\$ BILLIONS)	EXTERNAL COSTS RELATIVE TO GLOBAL GDP IN 2008	PROJECTED EXTERNAL COSTS IN 2050 (US\$ BILLIONS)	PROJECTED EXTERNAL COSTS RELATIVE TO GLOBAL GDP IN 2050
Greenhouse gas (GHG) emissions	4,530	7.54%	20,809	12.93%
Water abstraction	1,226	2.04%	4,702	2.92%
Pollution (SOx, NOx, PM, VOCs, mercury)	546	0.91%	1,926	1.20%
General waste	197	0.33%	635	0.39%
Natural resources				
<i>Fish</i>	54	0.09%	287	0.18%
<i>Timber</i>	42	0.07%	256	0.18%
Other ecosystem services	Not available (N/A)	N/A	N/A	N/A
Pollutants and waste				
Total	6,595	10.97%	28,615	17.78%

Source: PRI Association and UNEP Finance Initiative, 2010.

One of the fundamental fiduciary principles of the duty of loyalty is impartiality between different beneficiary groups, including different generations (Hawley, Johnson and Waitzer, 2011). Given the potential for shifting of wealth, environmental remediation costs and climate risks between young and older generations, failure of fiduciaries to adopt a sustainable development investment approach has fiduciary duty implications and raises questions about the ability of fiduciaries to efficiently allocate investment capital to growth opportunities and manage risks to economic growth and future portfolio returns.

BOX 2. UNPRI DESCRIPTION OF EXTERNALITIES

Externalities can affect shareholder value because they lead to a more uncertain, rapidly changing economic environment and greater systemic risks. Inefficient allocation of capital to highly polluting activities can cause a decline in asset value over time. For a diversified investor, environmental costs are unavoidable as they come back into the portfolio as insurance premiums, taxes, inflated input prices, and the physical cost associated with disasters. These costs could also reduce future cash flows and dividends. One company's externalities can damage the profitability of other portfolio companies, adversely affect other investments, and hence overall market return. Ultimately, externalities caused by companies could significantly affect the value of capital markets or their potential for growth, and with that, the value of diversified portfolios.

Source: UNPRI and UNEP-FI, 2010.

This fiduciary issue is not unique to the PRC. The nature of environmental and climate change risks are not confined by national boundaries. They are global in nature. As a result, environmental risks, costs and opportunities are becoming a focus of the current evolution in understanding of fiduciary responsibilities, as well as a central theme for upgrading institutional fiduciary governance and investment practices. Environmental and climate risk issues will drive evolution of fiduciary duties to meet the challenges of the 21st century.

BOX 3. FEATURES OF SUSTAINABLE ASSET MANAGEMENT

Externalities can affect shareholder value because they lead to a more uncertain, rapidly changing economic environment and greater systemic risks. Inefficient allocation of capital to highly polluting activities can cause a decline in asset value over time. For a diversified investor, environmental costs are unavoidable as they come back into the portfolio as insurance premiums, taxes, inflated input prices, and the physical cost associated with disasters. These costs could also reduce future cash flows and dividends. One company's externalities can damage the profitability of other portfolio companies, adversely affect other investments, and hence overall market return. Ultimately, externalities caused by companies could significantly affect the value of capital markets or their potential for growth, and with that, the value of diversified portfolios.

Source: Towers Watson, 2012.

Part of this evolution in fiduciary governance and investment practices has been recognition that prevailing application of the duty of prudence provides a free pass to fiduciaries that copy practices of other similar investors. This phenomenon has turned the standard of prudence into a "lemming standard" which discourages adoption of improved practices that respond to changing environmental circumstances and advances in knowledge (de Graaf & Johnson, 2009). Greater attention to upgrading fiduciary governance practices in order to reduce market volatility and economic risks caused by excessive investor herding behavior is desperately needed.

BOX 4 ATTRIBUTES OF WELL-GOVERNED FUNDS

- Mission clarity.
- Effective focusing of time.
- Investment committee leadership.
- Strong beliefs.
- Risk budget framework.
- Fit-for-purpose tests applied rigorously to manager lineup.
- Use of highly competent investment executive team.
- High level board competencies.
- Supportive compensation.
- Real time decision making.
- Exploit competitive advantage.
- Learning organization.

Source: Clark and Urwin, 2008.

Investment fiduciaries in many markets have recognized that improvements in sustainable investing require attention to the broader financial system in which institutional investors function. Governance improvements at investee companies, better investor training programs, increased communication and more robust reporting on environmental and other sustainability factors are important. The World Economic Forum has identified the following barriers in Table 4 and action areas in Table 5 for accelerating the transition to investment practices that support sustainable development.

TABLE 2. KEY BARRIERS IN SUSTAINABLE INVESTING

	INVESTOR LEVEL	CORPORATION LEVEL	AT INVESTOR-CORPORATE INTERACTION LEVEL	AT SYSTEM-WIDE LEVEL
Highest importance	Restrictions in conventional valuation models	Insufficient integration of sustainability factors into core business strategies, with ESG activities focusing more on creating environmental and social value rather than shareholder value	Lack of clarity on which ESG factors are financially material and over which time frame	Disproportionate focus on short term performance and issues with a near term impact
High importance	Lack of ESG expertise Lack of awareness and/or skepticism regarding the investment case	Lack of formal approach in setting ESG targets and holding senior staff accountable	Insufficient communication of link between ESG and corporate financial performance	Market failures, e.g., externalities are not priced
Medium importance	Herding behaviour due to “benchmark” focus	Insufficient integration of ESG criteria in corporations’ own capital allocation decisions	Disengagement and lack of active ownership Limited discussions between mainstream investors and corporate executives regarding ESG issues	Overconfidence in Efficient Market hypothesis and Modern Portfolio Theory
Low to medium importance	Lack of common definitions leading to confusion between sustainable investing and ethical investing Ambiguity about fiduciary responsibilities Weaknesses in fund governance and transparency	Difficulties in collecting the relevant ESG information Disconnect between sustainability managers and investor relations managers	ESG information often not user-friendly	

Source: World Economic Forum, 2011.

TABLE 3. ACTION AREAS

A. IMPROVE INFORMATION	B. STRENGTHEN COMPETENCIES	C. MODIFY INCENTIVE	D. ENHANCE GOVERNANCE
Make sure that financially material ESG information is widely shared between corporations and investors, and that ESG and financial information are communicated in an integrated way.	Make sure that both investors and corporate executives have the skill set to assess ESG factors from an economic value creation perspective.	Link incentives in the investment value chain more to long-term risk-adjusted financial performance. n.b.: This does not imply that all incentives in the financial system need to be long-term oriented. We recognize there is also a need for investing that is short-term in horizons and/or holding periods.	Strengthen the governance relationship between corporations’ owners – that is, shareholders – and management teams. This relationship is two-way and based on a mutual interest in optimizing shareholder value creation over the long run.

Source: World Economic Forum, 2011.

“Sustainability includes managing the impact that the business has on the life of the community, the broader economy and the natural environment in which it operates.”

Code for Responsible Investing in South Africa

6.0 Model Fiduciary Practices

While it is important to recognize that fit-for-purpose fiduciary duties, governance and investment practices do not automatically transfer from one market to another, there are a number of examples that illustrate the ongoing evolution of fiduciary duty toward more balanced and sustainable approaches. In addition, widespread implementation of sustainable investment practices in markets with fiduciary standards that encourage sustainable development requires more than creation of the right legal standards. The transition to sustainable development often also includes attention to changing fiduciary culture, governance and implementation practices.

Some jurisdictions are further along the evolutionary path to sustainable investing than others. Some are making mixed progress, with less-conflicted institutions able to adapt more quickly than those that have misaligned incentives, a culture that is hostile to fiduciary duties or weak governance. In addition, there are markets with fiduciary standards that provide only questionable support for sustainable investing in which institutional investor fiduciaries have been able to push the envelope by reframing sustainable practices in ways that fit the outdated fiduciary duty paradigm.

The jurisdictions that can best transition to sustainable development practices should be well positioned to enjoy competitive advantages long into the 21st century. The following are examples of investors and jurisdictions that are well along in the journey to becoming sustainable development fiduciaries.

South Africa

South Africa illustrates how a developing country can transition through investment industry initiatives to develop sustainable investment fiduciary standards that foster an enlightened fiduciary culture and provide the impetus for corresponding regulatory changes. In South Africa, pension funds are significant economic players, with total assets in excess of 50 per cent of national GDP and the largest pension fund in Africa, the Government Employees Pension Fund (GEPF). The GEPF is the 19th largest pension fund in the world (Towers Watson, 2013).

In 2009, the King Commission (headed by former South African Supreme Court Justice Mervyn King) incorporated sustainability reporting as part of an integrated report provision for companies in the King III “apply or explain” corporate governance code (Institute of Directors Southern Africa, 2009). This was followed in 2011 by development of a similar voluntary Code for Responsible Investing in South Africa (CRISA), with support of the Johannesburg Stock Exchange, the GEPF, the Institute of Directors and the local institutional investor community. The Code went into effect in 2012 (Institute of Directors Southern Africa, 2011).

The CRISA set forth the following voluntary principles, which were applicable to asset owners, insurance companies, investment managers and consultants:

- “An institutional investor should incorporate sustainability considerations, including environmental, social and governance, into its investment analysis and investment activities as part of the delivery of superior risk-adjusted returns to the ultimate beneficiaries.
- An institutional investor should demonstrate its acceptance of ownership responsibilities in its investment arrangements and investment activities.
- Where appropriate, institutional investors should consider a collaborative approach to promote acceptance and implementation of the principles of CRISA and other codes and standards applicable to institutional investors.

- An institutional investor should recognise the circumstances and relationships that hold a potential for conflicts of interest and should proactively manage these when they occur.
- Institutional investors should be transparent about the content of their policies, how the policies are implemented and how CRISA is applied to enable stakeholders to make informed assessments.”

Less than six months after CRISA was created, the Minister of Finance amended Regulation 28 of the Pension Funds Act to require that pension funds clearly define how they intend to integrate ESG criteria into the investment process (Bertrand, 2011). The Amendment includes the following statement.

Prudent investing should give appropriate consideration to any factor which may materially affect the sustainable long-term performance of a fund’s assets, including factors of an environmental, social and governance character. (Pension Funds Act, 1956: Preamble)

An industry-led association (Sustainable Returns for Pensions and Society) was then created to “integrate environmental, social, and corporate governance (ESG) considerations into the mainstream of retirement industry investment practices” (Jagdessi, 2012). Time will tell how effective these changes have been in transforming investment practices of institutional investor fiduciaries in South Africa.

United States

Institutional investors own 65 per cent of the equities of the 50 largest United States corporations. Pension funds are the largest institutional investor fiduciaries, with nearly 40 per cent of institutional assets in the aggregate (Conference Board, 2010). Private pension funds (for workers who are not employed by the government) are subject to the Employees’ Retirement Income Security Act (ERISA) fiduciary standard, which is set out in Table 1 above. These funds are also regulated by the Federal Department of Labor, which issues interpretations of ERISA. Government worker funds are subject to separate fiduciary standards, which are typically patterned after ERISA.

ERISA does not explicitly address sustainable investment practices. However, the Federal regulator has issued interpretive guidance stating that ERISA fiduciaries “may never subordinate the economic interests of the plan to unrelated objectives, and may not select investments on the basis of any factor outside the economic interest of the plan,” though non-financial factors can be considered when they do not adversely affect risk or returns (“Interpretive Bulletin,” 2008). While this interpretive bulletin is sometimes cited as precluding consideration of environmental, social and governance factors, the bulletin does not impede using an integrated investment approach which evaluates environmental, social and governance matters as part of a financial and risk analysis to help select the best investment portfolio to meet long-term investment objectives for beneficiaries (Youngdahl, 2011).

The largest United States pension investors are public funds for government workers, with the California Public Employees Retirement System (CalPERS) and California State Teachers Retirement System (CalSTRS) being in the top three. They provide examples of voluntary initiatives by pension fund boards to modernize their investment practices in order to meet the fiduciary challenges of the 21st century. Although their fiduciary standards are patterned after ERISA, both CalPERS and CalSTRS see sustainable investment practices as a part of their fiduciaries duties. CalPERS explains the financial basis for its sustainable investment approach as follows:

Our overriding investment priority is to grow our portfolio in a way that ensures we meet our commitments to our beneficiaries - not just today - but when the graduates of today retire in 40 years' time. This is why sustainability matters to our fund. . . . In the longer term, we recognize that rising demand for food and resources globally, coupled with the likely effects of climate change, will have a potential impact on risk-adjusted returns. . . . Companies need physical capital such as equipment, electricity, water, transport and buildings for example. This gives us an interest in the environment. This is the context for our thinking on "ESG issues"— they represent the three forms of capital that companies use to create value. Understanding the interplay will inform our investment decisions. And long-term value creation is at the heart of sustainability. (California Public Employees' Retirement System, 2012, p. 4)

In addition, CalPERS recently completed a process to develop a set of investment beliefs that will guide its strategy in meeting fiduciary obligations. One of the key investment beliefs provides that:

As a long-term investor, CalPERS must consider risk factors, for example climate change and natural resource availability, that emerge slowly over long time periods, but could have a material impact on company or portfolio returns. (California Public Employees' Retirement System, 2013, p. 6)

CalSTRS also has an environmental, social and governance (ESG) risk policy in place that requires all internal and external investment managers for the fund to evaluate ESG risks when making investments. The risk factors include environmental and climate change issues. CalSTRS explains:

Since CalSTRS is a long-term investor and may hold an investment in a corporation or entity for decade after decade, short-term gains at the expense of long-term gains are not in the best interest of the Fund. Sustainable returns over long periods are in the economic interest of the Fund. Conversely, unsustainable practices that hurt long-term profits are risks to the System's investment. (California State Teachers' Retirement System, 2013, p. A-18)

Both pension funds are working to integrate these policies into their investment practices and interactions with portfolio companies. For example, CalPERS and CalSTRS recently joined in sending a letter with other United States institutional investors responsible for managing over US\$1 trillion in assets to companies in the Russell 1000 index, asking for greater attention to managing of and reporting on sustainability issues. The letter advised:

We look for alignment of sustainability considerations with supplier standards and performance expectations, as well as measurable improvements in areas such as GHG emissions, energy efficiency, water management, and human rights, including worker safety. This is critical for ensuring the effectiveness of sustainability practices. As shareowners, we believe companies should be open and transparent with stakeholders on all material issues, including those often hidden environmental, social, and governance risks. We encourage you not only to design and implement a robust sustainability strategy, but also to demonstrate to shareowners and other stakeholders how effectively you are managing sustainability risks and opportunities. . . . As shareowners, we believe companies should be open and transparent with stakeholders on all material issues, including those often hidden environmental, social, and governance risks. We encourage you not only to design and implement a robust sustainability strategy, but also to demonstrate to shareowners and other stakeholders how effectively you are managing sustainability risks and opportunities. (CERES, 2011, p. 2)

The Netherlands

Pension fiduciaries are major investors in the Netherlands, with assets totaling nearly 140 per cent of GDP (Organisation for Economic Co-operation and Development, 2012). Funds are typically organized as foundations and established under a contractual arrangement between the fund and employer. The Dutch pension system ranks as one of the top three most effective pension systems in the world, along with Denmark and Australia (Australian Centre for Financial Studies, 2012). Given that the Netherlands is a European Union member state, Dutch pensions are subject to both the EU Pension Directive and the Dutch Pensions Act, which are not allowed to conflict with provisions of the Pension Directive (Maatman, 2004). However, Dutch pension funds have voluntarily adopted policies to encourage sustainable environmental, social and corporate governance practices.

Pension fiduciaries are required to invest assets as a “prudent person,” solely in the interests of the fund’s members and beneficiaries, using a total portfolio approach with proper diversification. There are no specifically precluded investments, except as to holdings in a contributing employer. Pension funds are allowed to invest in all markets, asset classes and instruments, so long as they are professionally managed and are transparent in regard to development of an investment policy and how it is implemented (Maatman, in press).

There is no provision in the Dutch Pension Act specifically dealing with sustainable or responsible investment. However, the “prudent person” principle allows funds to consider non-financial issues so long as they do not dominate investments such that the investment policy no longer leads to an acceptable risk-profit profile (Dutch Association of Investors, 2012). In practice, 98 per cent of Dutch pension funds have a socially responsible investment policy in place (Dutch Association of Investors, 2012).

PGGM, one of the largest Dutch pension funds, reports that its Responsible Investment Program has six pillars (PGGM, 2012):

- Integration of ESG analysis into investment processes.
- Making targeted ESG investments which are intended to generate financial and social returns.
- Voting proxies to exercise shareholder rights.
- Engaging with companies to seek improvements in ESG management.
- Participating in legal actions to recover losses to fraud and enforce good corporate conduct.
- Divesting or not investing in companies or bonds of governments that are engaged in socially irresponsible behavior that is repugnant to PGGM or its clients.

Among other things, the targeted ESG investments program at PGGM is focused on climate change, environmental and agricultural issues. During 2012, PGGM invested €4.2 billion in 22 different targeted ESG investments (PGGM, 2012).

Norway

Norway illustrates government imposition of a sustainable investment mandate. The Government Pension Fund Global is currently the world’s largest sovereign wealth fund with US\$760 billion in assets. It was established in 1990 to manage Norway’s petroleum revenue on behalf of the Ministry of Finance. Because it is so large and is 60 per cent invested in equities, the fund owns an average of 1.25 per cent of every listed company in the world, except that the allocation to Europe results in an average 2.5 per cent ownership position (Milne, 2013).

Although called a pension fund and designated as a tool to manage the financial challenges of Norway's aging population, it has no formal pension liabilities. The fund is managed as a separate account by Norges Bank Investment Management (NBIM) under a contract with the Ministry of Finance (NBIM, 2010). The contract requires that the fund be managed with the goal of achieving the highest possible return. The contract also contains several provisions on responsible investment management:

A good return in the long term is regarded as being dependent upon sustainable development in economic, environmental and social terms, as well as well-functioning, legitimate and effective markets. The Bank shall have internal guidelines for integrating considerations of good corporate governance and environmental and social issues in investment activities, in line with internationally recognized principles for responsible investment. The integration of these considerations shall occur with regard to the investment strategy and the Bank's role as a financial manager. In executing its management assignment, the Bank shall give priority to a long-term horizon for the investment strategy and to the investment portfolio being invested widely in the markets included in the investment universe. . . . The Bank shall actively contribute to the development of good international standards in the area of responsible investment and active ownership. (NBIM, 2010, Section 2.1)

The Bank has established six focus areas for its Responsible Investment Program and undertakes specific initiatives involving active dialogue with companies, voting of proxies, offering shareholder resolutions, participation in litigation and engaging with regulators and standard setters. The focus areas are:

- Climate change
- Water management
- Children's rights
- Equal treatment of shareholders
- Shareholder influence and board accountability
- Well-functioning, legitimate and efficient markets

In the water management area, the Bank has established formal expectations for how portfolio companies will address water quality and scarcity. It is engaging with companies in the food, agriculture, pulp and paper, pharmaceuticals, mining, water supply and electricity production sectors on strategies for water risk management.

As an additional aspect of the fund's investment program, the Ministry of Finance has established a separate Council on Ethics to identify and evaluate companies that should be divested or excluded from investment based on established guidelines that are grounded in Norwegian values and international standards (Council on Ethics, 2012). The standards include factors such as severe environmental damage, serious human rights violations, production of cluster munitions, nuclear weapons or landmines, and manufacture of tobacco products. The Ministry of Finance (upon advice of the Council on Ethics) may put a company under observation, investigate or undertake engagement on the issue or notify the Bank that the company has been excluded from the investment universe and must be sold within two months. At the end of 2012, nearly 50 companies were excluded from investment. The Council can also ask for a company to be removed from the exclusion list if circumstances change (Council on Ethics, 2012).

In late 2013, an independent Strategy Council appointed by the Ministry of Finance issued a report recommending that duties of the Council on Ethics be transferred to the Bank and integrated into its investment program (Strategy Council, 2013). The fund has also come under public criticism for not being sufficiently active in addressing corporate governance problems at portfolio companies. In response, the Bank has appointed three governance experts to a new Corporate Governance Advisory Board and announced it intends to establish a dialogue with the board chairs at its largest equity holdings and seek to influence the choice of director candidates (Milne, 2013).

7.0 Summary

The Brundtland Commission defined “sustainable development” as development that “meets the needs of the present without compromising the ability of future generations to meet their own needs” (United Nations, 1987, p. 37). Adoption of a fully evolved understanding of fiduciary duties, along with robust reporting and enforcement, is essential to sustainable development.

The details of how to best align understanding and application of fiduciary duties with sustainable development should be tailored to a jurisdiction’s culture and legal system. However, model fiduciary duty practices in one jurisdiction can provide guidance as to what is prudent in another. Hopefully, the examples described in this paper will offer assistance to the PRC as it evaluates the evolution of fiduciary duties in China to address environmental challenges and ecosystem resource constraints in development of plans for promotion of sustainable and harmonious development.

Finally, fiduciary duties alone have no effect. It is only through implementation of governance and investment practices that fiduciary duties take on life. The World Economic Forum and the environmental organization CERES have laid out the following roadmaps in Tables 6 and 7 for guidance in transitioning to institutional investor fiduciary practices that will support sustainable development.

TABLE 4. MINDSET CHANGES TO ACCELERATE THE TRANSITION TOWARDS SUSTAINABLE INVESTING

	CONVENTIONAL MINDSETS		NEW MINDSETS
Investors (asset owners & managers)	Corporate sustainability strategies undermine the financial performance of companies and dilute investment returns.		Sustainability considerations—if effectively integrated into core business strategies—have the potential to strengthen the financial performance of companies.
	ESG indicators are non-financial indicators.		ESG indicators are direct and indirect drivers of business.
	Financial markets are highly information efficient and therefore if ESG information is material, it will be priced in.		Financial markets are efficient at pricing in certain types of information and less efficient at pricing in others; this can be the result of—for example—heuristic biases, bounded rationality, and distortive incentives.
	Investors are “shareholders” (in the sense of feeling hardly responsible for the actions and course of the company).		Investors are “shareowners” (in the sense of feeling adequately responsible for the actions and course of the company).
	Investors are the primary stakeholders.		Investors are important stakeholders, as are employees, customers, society, and other critical groups.
	Thinking of ESG mainly in terms of risks and compliance.		Thinking of ESG in terms of opportunities and value created as well.
	Fiduciary duty is transactional, and if asset owners don't specify ESG in their mandates, then asset managers can't consider ESG.		Fiduciary duty is about professional responsibility and implies that asset managers should consider ESG when in asset owner's best interests.
Corporate executives	If investors don't ask about ESG issues, we won't explicitly discuss.		We need to create a dialogue with investors on all issues that are financially material today and in the future,
	Investments that make long term sense are not worth making because capital markets mainly care about the short term costs and not about the long term benefits.		If investments make long term sense, we should make them.
	ESG is bolted onto the core business, and is the prime responsibility of the ESG department.		ESG is central to the core business and is a widespread responsibility; incentives throughout the business should reflect that.

Source: World Economic Forum, 2011.

TABLE 5. TEN ACTION STEPS FOR SUSTAINABLE INVESTING

Step 1:	Establish a commitment to sustainable investment through a Statement of Investment Beliefs.
Step 2:	Establish board level oversight of sustainability policies and practices.
Step 3:	Identify sustainability issues material to the fund.
Step 4:	Evaluate asset allocation for material sustainability risks.
Step 5:	Select sustainable investment strategies best suited to the fund's objectives.
Step 6:	Require sustainable investment expertise in manager and consultant procurement.
Step 7:	Evaluate manager performance against sustainable investment expectations.
Step 8:	Apply sustainable investment strategies to all asset classes.
Step 9:	Establish engagement strategies and proxy voting guidelines consistent with sustainable investment goals.
Step 10:	Support policies and market initiatives that promote a sustainable global economy.

Source: CERES, 2013.

8.0 *Next Steps*

The PRC appears to be at an appropriate point in time to develop guiding fiduciary principles for investment agents with delegated responsibility for management of increasingly larger sums of money. Having standards of conduct, reporting and investment compliance for fiduciary agents will become systemically more important for beneficiaries and for society over time. The Green Credit Guidelines issued by the China Banking Regulatory Commission might provide a good starting point for exploring development of widely applicable fiduciary, governance, reporting and enforcement standards (China Banking Regulatory Commission, 2012). The initiative on Greening China's Financial Markets offers a potential vehicle for pursuing such plans as part of the broader package of financial market reforms designed to promote sustainable development.

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EXHIBIT 6

Reclaiming Fiduciary Duty Balance

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Fundamental fiduciary principles have survived intact for centuries, yet their interpretation has been dynamic. Given changes over the past few decades in global economic, capital management, and market structures, we appear to be at another inflection point in the understanding of fiduciary principles. Years of focus on the fiduciary duty of prudence has generated myopic investment herding behaviors, undermined intergenerational pension equity, and disrupted attention to the fiduciary duties of loyalty and impartiality. Reclaiming fiduciary duty balance between prudence, loyalty and impartiality is critical to sustaining pension promises. It would encourage better alignment of pension service providers' supply chain interests, adoption of fit-for-purpose pension fund governance practices, and implementation of precautionary risk management policies.

Keywords: Fiduciary Duty, Impartiality, Modern Portfolio Theory, Pension Fund, Risk Management

The Dynamic Nature of Fiduciary Duty

Fiduciary duty is grounded on a relatively stable set of legal principles that have survived for centuries. However, interpretation of fiduciary principles can be quite dynamic. We are again at an inflection point, where our understanding and appreciation of fiduciary duty is evolving rapidly. In response to recent changes in financial markets, economic changes, and changes in the asset management industry, fiduciaries are examining the continued appropriateness of norms and beliefs carried over from the twentieth century.

Trends of the past three decades have produced a concentration of capital managed by fiduciaries on a global basis, often against similar short-term and market-relative benchmarks. Increased market complexity has generated a longer and more conflicted chain of service providers that have growing influence over governing fiduciaries. Despite a series of unexpected market shocks, prevailing theories and practices have not been fully adjusted to reflect systemic and long-term risks that threaten to undermine the security of the pension (and other retirement savings) plan “promise.”

These developments present a compelling case for evaluation of how fiduciary principles and practices might be better aligned to promote sustainable pension (and other retirement investment) success. Such a process is likely to be an extended journey of discovery rather than a single event of enlightenment. This article identifies recent changes and fundamental issues for examination in the quest to reclaim fiduciary duty fundamentals.¹

Changes in the Market and Risk Environment

The extent of change since the mid-twentieth century in global financial markets, regulatory frameworks, economic theory, risk management, and the role played by mandatory savings plans has been remarkable. For pension fiduciaries, the most important transformations have included the following:

- **Growth of Pension Funds:** Assets under the management of pension fiduciaries have grown from an insignificant part of economies to huge pools of capital. Total pension fund assets now exceed national GDP in the Netherlands, Switzerland, and Iceland. Across all countries in the Organisation for Economic Co-operation and Development

(OECD), the average ratio of pension assets to GDP in 2009 was 67%. In the United Kingdom, it was 81%; in Australia, 82% (OECD 2010). Institutional investors collectively own 73% of stock issued by companies in the Fortune 1000. Pension funds alone hold the largest ownership block, with almost 30% (Tonello and Rabinov 2010).

- **Expansion of Service Provider Influence:** Innovation in the creation of financial instruments, products, and services has produced a far more complex investment marketplace. Nearly every aspect of investment management now requires specialized expertise. This has generated a vast new industry of service providers upon whom pension trustees rely.
- **Exposure to Systemic and Extra-Financial Risk:** Use of indexed investing has skyrocketed. Furthermore, Ibbotson (2010) reports that 75% or more of a typical portfolio's returns now come from general market exposure (beta) rather than benchmark outperformance (alpha). The recent financial crisis illustrates this phenomenon, which produced an unexpected global correlation of risks that lopped \$5.4 trillion (20%) off global pension assets in 2008 alone, accelerated the closure of defined benefit (DB) pension plans, and ravaged retirement security for millions of plan participants (Yermo and Severinson 2010).²
- **Focus on Short-Term Returns:** The average holding period for shares listed on the New York Stock Exchange has gone from over five years in 1970 to less than one year today (Conference Board 2003).³ Mercer and the IRRC Institute (2010) report that nearly two-thirds of portfolio managers have higher annual portfolio turnover than claimed, some by as much as 200 percent. The CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics studied investor time horizons and concluded, "The obsession with short-term results by investors, asset management firms, and corporate managers collectively leads to the unintended consequences of destroying long-term value, decreasing market efficiency, reducing investment returns, and impeding efforts to strengthen corporate governance" (Krehmeyer, Orsagh, and Schacht 2006).⁴ The World Economic Forum (2011b) warns that short-termism is being fostered through the adoption of regulatory frameworks that constrain the ability of investors with long-term liabilities to use long-term investment strategies.

Evolving Investment Theory Assumptions

Modern portfolio theory (MPT) became accepted as the dominant approach for prudent investment and risk management practices toward the end of the twentieth century. It transformed the legal framework governing fiduciaries. However, recent developments in economics and behavioral finance have built a substantial critique of many assumptions underlying MPT and related

academic theory.⁵ An adjustment in prevailing investment theory is likely to follow, particularly with respect to the following:

- **Understanding of Risk:** MPT assumes that investment risk falls into four main types: market, credit, liquidity, and operational. The rapid growth of financial instruments has led to underestimation and mispricing of risk, primarily because of market complexity and interactions among various risk types. Uncertainty (risk that is neither necessarily known nor calculable) has not been considered, though its effects have become evident (Knight 1921; Bookstaber 2007).
- **View of Markets:** MPT assumes that (i) investors are rational; (ii) information is symmetric, cost free, and immediately actionable; (iii) if markets are temporarily inefficient, they will revert to being efficient with the help of arbitrage; and (iv) returns are statistically stochastic and have been widely interpreted as following a normal bell curve distribution.⁶ The growing dominance of large institutional investors using similar investment strategies and risk management techniques has produced returns that are increasingly linked. The resultant herding and cascading effects reflect the failure of MPT to take into account the effect of its own success and widespread adoption.
- **Beliefs about Investors:** MPT also presumes that investors (i) are risk averse; (ii) make decisions based on expected utility; (iii) have linear and consistent preferences; and (iv) are price takers who cannot individually affect a security's price. MPT concludes that the overall risk of a portfolio depends on the risk of each asset in the portfolio, the proportion of the portfolio in that asset, and the correlations among different portfolio assets. In critical instances, each of these assumptions (and conclusions) has not held.
- **Systemic Risk:** From the original formulation of MPT, Sharpe (1964) introduced concepts of systemic and idiosyncratic risk, beta, diversification, and the linear relationship between beta (a measure of portfolio risk) and expected return. The critical point for contemporary risk management is the assumption that idiosyncratic (asset specific) risk can be diversified away (including through leverage), increasing portfolio return and / or decreasing portfolio risk, beta. Left unexamined was the impact of systemic risk, which Sharpe held as independent of idiosyncratic risk and which he argued (correctly in our view) could not be diversified away. Systemic risk was seen as strictly exogenous.⁷

The ideological power of "labeling" financial markets as "efficient" (i.e., asserting that they do not cause or amplify economic instability) or "rational" has been undermined. This has implications for the application of fiduciary norms and merits the attention of institutional fiduciaries.⁸

The Origins of Fiduciary Norms

Fiduciaries face the same challenges whether they oversee funds structured as trusts, mutual benefit societies, foundations, contractual pools of segregated assets, or joint stock companies. While the following discussion tracks the evolution of fiduciary duty applicable to trusts in common law jurisdictions, the same fundamentals apply to civil law regimes and contractual pension schemes.⁹

Fiduciary duty has its roots in Germanic, Roman, and Islamic trust law (Avisheh 1996). The contemporary trust developed as a means to overcome feudal restrictions on the transfer of land and was imported to English common law from civil law structures (Lupoi 1999). The essential concept was that underlying assets were held in trust, under separate title from the designated beneficiaries, and managed by the trustee on behalf of designated beneficiaries (Langbein 1997). Trustees initially had few powers or managerial responsibilities and were most often unpaid. The trustee's role has evolved dramatically over time.

Quantitative Standards

Following the collapse of the “South Sea Bubble” in the early eighteenth century, English courts of equity required trustees to restrict their investments to government debt and well-secured mortgages. This was the genesis of the “legal list” approach, which restricted the range of permitted trustee investments (Keeton 1971).¹⁰

In the United States, *Harvard College v. Amory* (decided in 1830) took a different approach. The court articulated an objective behavioral standard for trustee investment practice, focusing on conduct and imposing duties of care and loyalty, rather than prescribing permitted investments. While it admonished against speculation, it recognized that risk is inherent in investment decisions.

However, the flexibility of this approach was quickly circumscribed. For example, in *King v. Talbot* (1869), the court determined that it was imprudent for trustees to invest in corporate stock and limited them to investments in government bonds and mortgage-backed instruments. The New York legislature followed suit in 1889, enacting legislation that restricted trust investments to government bonds and mortgages, unless otherwise allowed by the trust creator. As recently as the 1970s, stock investments were widely viewed as imprudent for trust fiduciaries.¹¹

The Prudent Person Standard

Over time, the changing market environment made this restrictive approach impractical. Statutory expressions of a “prudent person” rule for trustee investment began to supersede the legal list approach by the mid-twentieth century (Friedman 1964). The need for trustees to effectively hedge against inflation and the superior performance of equities (and foreign securities) also led to the introduction of baskets for securities that fell outside of legal lists, to facilitate diversification.

With growing acceptance of MPT in the 1970s and after, the abandonment of prescribed investment categories became common. The *Employee Retirement Income Security Act* (ERISA), adopted in 1974 to govern American private pension funds, illustrates this legal paradigm shift from restricted trustee powers to one that confers broad managerial discretion on trustees, within the bounds of overarching fiduciary obligations. Most American public pension plans also adopted similar standards.¹²

ERISA also repealed the prior rule against delegation of investment responsibilities, in response to the growing complexity of managing financial assets and the need for trustees to rely on delegation to professionals to discharge their obligations. This evolution was subsequently reflected in modifications of the Restatement (Third) of Trusts (1992, §171).

Some variation of the prudent person rule has now been adopted in most common law and civil law countries with mature capital markets. It is generally effected by contract in civil law jurisdictions.

The Prudent Investor Standard

One variation of the *prudent person* standard was the shift to a *prudent investor* standard in the 1992 revisions of the Restatement of Trusts and the *Uniform Prudent Investor Act* of 1994, as well as the British *Pensions Act* in 1995. These changes reflected a recognition that, in accordance with MPT, prudence should be measured on an overall portfolio basis, rather than by discrete consideration of each particular investment. MPT also elevated the prudence standard by recognizing that managing pension fund assets requires significant levels of professional expertise beyond that of the common person.

The *Uniform Prudent Investor Act* (National Conference of Commissioners on Uniform State Laws 1997b) was adopted to facilitate implementation of the standards for prudent trust investment advanced in the Restatement (Third). It made five major alterations in prudent investing concepts by

- (a) Focusing on the total portfolio, rather than individual investments
- (b) Defining the fiduciary's central concern as the trade-off between risk and return
- (c) Removing all categorical restrictions on types of investment
- (d) Prescribing diversification as integral to prudent investing
- (e) Reversing the non-delegation rule with respect to investment and management functions

It also confirmed a “prudent professional” standard, to clarify application of a higher standard of care when a trustee is an expert or professional with a higher level of skills (e.g., investment professionals).¹³

Fiduciary Duty Is a Dynamic Concept

This evolution of fiduciary duty demonstrates that fiduciary law is not a static concept, nor is it tied to a single investment theory. Rather, it is a flexible set of principles that have been subject to varying interpretations over time.

When explaining rejection of prior interpretations of fiduciary duty in the early 1990s, the Restatement of Trusts (Third) aptly observed, “Trust investment law should reflect and accommodate current knowledge and concepts. It should avoid repeating the mistake of freezing its rules against future learning and developments” (1992, §227, Introduction).

Fiduciary duty is a process-oriented standard which guides rather than dictates investment decisions. However, a generation of investment professionals has spent entire careers in a legal environment shaped by MPT. This has encouraged the view that fiduciary duty mandates a single approach to making investment decisions. Absent a broadly accepted prescriptive alternative, there remains strong cognitive resistance to a dynamic understanding of the legal standards.

Pension Fiduciary Duty Today

While the exact formulation of fiduciary duty varies between jurisdictions, the main concepts are relatively consistent.¹⁴ Fiduciaries are generally required to discharge their duties

- (a) Solely in the interest of participants and beneficiaries
- (b) For the exclusive purpose of providing benefits
- (c) Impartially, taking into consideration differing interests of various participant and beneficiary groups
- (d) With the care, skill, and prudence exercised by similar fiduciaries, including as to diversification of investments
- (e) Incurring only costs that are appropriate and reasonable
- (f) In accordance with governing law and documents¹⁵

Duties (a) through (c) are often referred to as the *duty of loyalty*, while (d) is called the *duty of prudence or standard of care*. All must be grounded in the specific context – that is, the nature of the pension promise and success in delivering on it.¹⁶

Pension Fiduciary Standards Are Stricter Than Standards for Corporate Directors

Though often compared to corporate directors in terms of statutory duties, pension fiduciaries are held to a higher standard of conduct that has different legal roots.¹⁷ If a trustee's conduct is not prudent, s/he may be liable to the beneficiaries.¹⁸ Also, the duty of loyalty owed by pension fiduciaries is to the actual human beneficiaries, not to the legal entity. There is not the same ambiguity as may be inherent in corporate law, which imposes a duty to act in the best interests of “the corporation.” Pension fiduciaries need not concern themselves with raising capital, so there are few market-based (or other) checks to discipline their conduct. Beneficiaries do not enjoy the liquidity of capital markets or (typically) the ability to oust trustees.

The governance remit of fund trustees is also different from that of corporate directors. The essence of private enterprise is risk taking; in contrast, the history of fiduciary standards for investment of pension fund assets is singular in its focus on preserving trust property by risk mitigation and cautious investment behavior (Sitkoff 2004).

Devolution of the Pension Fiduciary Standard of Care

The standard of care (also known as the duty of prudence) encourages pension fiduciaries to adhere to practices followed by similar institutional investors (Galler 2002).¹⁹ However, with growth in pension assets over the past few decades and increased investor focus on short-term investing, herding can function like an economic wave generation machine (Johnson and de Graaf 2009). Collectively, pension fund investors can *create market volatility and undermine sustainable wealth creation* when they invest with the same short-term bias and follow each other around the markets.

Excessive reliance on peer comparisons has also produced a shift toward using relative performance metrics rather than measuring performance on a risk-adjusted basis and against the best interests of beneficiaries. Perceived liability exposure

increases for fiduciaries that are out of step with common practice (and results). Courts can easily compare their performance to that of a similar portfolio or a recognized index to evaluate prudence and assess damages. This often distracts fiduciaries from focusing on the interests of plan participants and is likely to distort efficient markets (Del Guercio 1996; Thomas and Tonks 2001).

The word “prudence” derives from the Latin term for “foresight” and means “acting with or showing care and thought for the future.”²⁰ Peter Drucker argued this 35 years ago in *The Unseen Revolution* (1976), warning that pension funds would face the twin challenges (and opportunities) of becoming dominant owners as aging and longevity became key social, economic, and political issues. In an epilogue to the 1996 edition (in which he noted that no book of his had been more on target or more totally ignored), Drucker argued in favor of a shift away from short-term thinking in favor of a focus on defining performance (and results) as “maximizing the wealth-producing capacity of the enterprise” (1996, 218).²¹ This, he argued, should define the role of institutional investors (and managerial accountability more generally).

The Duty of Impartiality

A recent Bank of England study found that “investment choice, like other life choices, is being re-tuned to a shorter wave-length,” leading to irrational investment decisions – particularly with respect to projects of longer duration, which often yield the highest private (and social) returns (Haldane and Davies 2011). Their data suggest that in the United Kingdom and the United States, 10-year-ahead cash flows are valued as if received 16 or more years ahead, and little or no value is ascribed to cash flows more than 30 years ahead. Haldane and Davies found that this myopic discounting is on the increase and is distorting efficient capital allocation by diverting investment capital away from future growth, despite the associated risks.

However, the duty of impartiality, which is part of the duty of loyalty, requires that fiduciaries balance short-term and long-term considerations.²² They must identify and impartially consider the conflicting interests of different beneficiary groups, including those of current and future retirees (Restatement of Trusts, Third, 1992).²³ While impartiality does not mandate uncompromising equality, it does apply across all trustee duties. It requires that “conduct in administering a trust cannot be influenced by a trustee’s personal favoritism ... nor is it permissible for a trustee to ignore the interests of some beneficiaries merely as a result of oversight or neglect” (Restatement of Trusts, Third, 1992, §79, Comment (b)).²⁴

Most importantly, the duty of impartiality imposes “procedural” duties. Not only must actual results reflect due regard for different beneficiaries’ interests, but the “process of administration itself,” including communication with beneficiaries, must be impartial (Wakeman, Franklin, and Ascher 2006, §17.15).

The Duty of Impartiality Requires Attention to Long-Term Issues

For many plan participants, pension management results have become unfair, particularly from an intergenerational perspective.²⁵ While these outcomes may not present legal problems under the duty of prudence – common management approaches and poor results may be widely shared – the duty of impartiality presents a more clouded picture. In hindsight, at least, it is no surprise that widespread adherence to investment practices focused on producing short-term results (at the expense of longer-term earnings and capital growth) comes with “consequences of destroying long-term value, decreasing market efficiency, reducing investment returns, and impeding efforts to strengthen corporate governance” (Krehmeyer et al. 2006, 1).

The duty of impartiality assumes competence with respect to long-term value creation and risk mitigation. To be clear, the issue is not that a short-term outlook is wrong but, rather, that a deliberate balance should be struck between mission and risk-adjusted returns, including related opportunity costs. Fiduciaries must ensure that their decision-making processes balance allocation of capital between near-term needs and future wealth creation and consider the potential transfer of risks between participant generations. Intergenerational wealth maximization requires active consideration of a range of factors beyond narrow financial criteria.

Dilution of the Duty of Loyalty

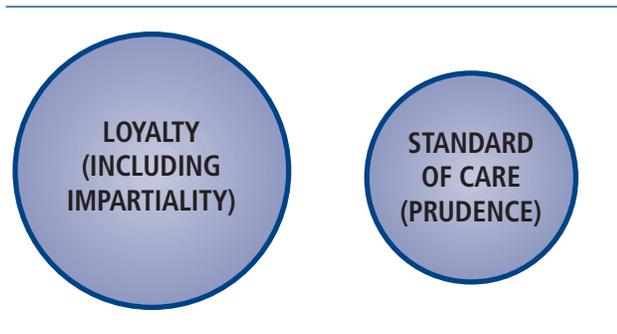
Pension trustees have an overriding “duty to administer the trust solely in the interest of the beneficiaries” and are “prohibited from engaging in transactions that involve self-dealing or that otherwise involve or create a conflict between the trustee’s fiduciary duties and personal interests” (Restatement of Trusts, Third, 1992, §78 and Comment (b)).²⁶ Uncompromising rigidity of this rule is not just a formality, and applies to both defined benefit and defined contribution plans.²⁷ “The courts have consistently held that this inflexibility is essential to its effective operation ... First, the courts have acknowledged that it is difficult, if not impossible for a person to act impartially in a matter in which he has an interest ... Secondly, the courts have realized that fiduciary relationships lend themselves to exploitation

... Finally, the courts have made much of the fact that disloyal conduct is hard to detect” (Hallgring 1966, 808–11).

This focus on process and alignment of interests makes the duty of loyalty a demanding standard. “The fact that the [trustees] might have properly decided to choose the same course of action had they engaged in an unbiased and adequately informed process does not excuse how they went about reaching this course of action” (*McNeil v. Bennett* 2001, 213).

Figure 1 provides a visual representation of the relative priority of the duty of care and duty of loyalty. “When duties of loyalty and care collide, courts generally resolve the conflict in favor of the duty of loyalty representing minimum conduct to which the fiduciary must adhere” (Laby 2004, 78). Given primacy of the duty of loyalty, greater allocation of fiduciary time and resources to implementation of loyalty principles may be required.

Figure 1: Relative Priority on Conflict of Main Fiduciary Duties



Service Providers and Loyalty

Increasing financial market complexity, along with the resultant growth and influence of the advisory service supply chain, has eroded the protections afforded to beneficiaries by the duty of loyalty. In the United States, the Government Accountability Office reports that pension consultant conflicts of interest appear to be associated with lower investment returns (Jeszeck 2009). In response, the Department of Labor has proposed new regulations under ERISA to bring within the definition of *fiduciary* certain consultants, advisors, and appraisers who “significantly influence the decisions of plan fiduciaries, and have a considerable impact on plan investments” (US Department of Labor 2010).

A CREATE-Research survey of European pension fund executives and asset managers offers insight into the practical ramifications of these conflicts of interest, concluding that “there is a widespread perception in the pension world that the investment industry is perverse in one crucial sense: its

food chain operates in reverse, with service providers at the top and clients at the bottom. Agents fare better than principals” (Rajan 2008).

By delegating duties to qualified experts, trustees in many jurisdictions can shift liability risk to the delegates. This can create perverse incentives for trustees to delegate responsibility while the delegates try to avoid liability by providing advice but not making final decisions – or seeking indemnity (Stewart 2009). The result can be a circular system in which no one takes responsibility and the interests of agents trump those of pension beneficiaries. Nevertheless, the duty of loyalty assigns to governing fiduciaries the ultimate responsibility for oversight of supply-chain management conflicts of interest (which have become the norm in most commercial sectors).

Pension Board Governance Practices

Implementation of the duty of loyalty presents particular challenges at the governing fiduciary level. Studies of pension fund governance practices have shown that good governance is associated with increased returns (Ambachtsheer, Capelle, and Lum 2008). However, recent findings suggest that many pension funds do not have the governance capacity to adapt their practices for better success or to distinguish between (let alone act upon) the differences between short-term issues and long-term commitments (Clark and Urwin 2010).

Ambachtsheer (2010) goes further in identifying key “success drivers” for tomorrow’s pension funds:

- Aligned interests (conflict free)
- Good governance (requisite skills and accountabilities)
- Sensible investment beliefs (focusing on long-term wealth creation and effective risk management)
- Right-scaled institutions (big enough to be internally competent and competitive)
- Competitive compensation (to attract the best)

Again, as the empirical support for the relevance of such factors becomes compelling, it is arguable that failure to consider them has fiduciary duty implications.

For example, recent research has identified good governance practices that are linked with pension fund success, including

- Selection of governing Board members with relevant skills and knowledge
- Development of a Board self-improvement culture
- Clear understanding of the Board’s mission and its investment beliefs
- Sufficient fund size to allow cost-effective management of assets

- Competitive staff compensation to permit acquisition of internal expertise
- Insulation from conflicting political or third-party agendas
- Clarity of Board and staff roles about delegation of management responsibilities²⁸

While some of these factors can be beyond the control or influence of governing fiduciaries, most of them are not. Failure to consider material factors in the success of fiduciary governance raises concerns about the alignment of process with beneficiaries' interests and compliance with the duty of loyalty.

Management of Service Provider Conflicts

Similarly, governing fiduciaries have an obligation to ensure that procedures are in place to identify and manage conflicts of interest in their service provider chain. Regulatory initiatives are beginning to refocus on this duty, but regulation is no substitute for process and contract changes to improve management of conflicts. Attention to the development of an effective program for managing conflicts could include the following components:

- **Imposition of Fiduciary Liability Throughout the Supply Chain:** While ERISA states that fiduciary liability attaches to anyone exercising discretion over plan assets (s. 3(38)), trustees have tended to view delegation as a shield (rather than a sword).²⁹ Even in jurisdictions where asset managers and consultants are not treated as fiduciaries, they could be contractually required to put beneficiaries' interests first through the use of selection process and contract requirements.
- **Use of Conflicts Screening in Selection of Service Providers:** The legal obligation to view conflicts of interest from beneficiaries' perspectives and focus on avoiding conflicts rather than monitoring them argues for selecting service providers without conflicts whenever practicable.³⁰
- **Alignment of Service Providers' Interests with Those of Fund Participants:** As noted above, contract mandates and fee structures could be more clearly aligned with the duty of impartiality to better incentivize service providers to achieve goals that serve the short-term and long-term interests of various beneficiary groups in a balanced manner.
- **Reporting to Fund Participants on Management of Conflicts:** Given the opacity of risks associated with conflicts of interest, transparency with respect to identification and management of conflicts is particularly important. This includes not only service provider conflicts of interest but also efforts to balance the divergent interests of different beneficiary groups.

- **Monitoring of Conflicts and Enforcement of Standards:** More attention could be paid to contractual mandates for reporting and ongoing oversight of areas where service providers are likely to have conflicts. For example, there may be situations in which providers have competing interests that complicate compliance with the duty of impartiality, as when a manager with a short-term strategy votes proxies on matters relating to systemic risk exposure over the long term or a manager votes proxies involving executive compensation matters at a company with which it also has a business relationship.

Precautionary Risk Management

Future value creation and management of risks for sustainable delivery of the pension promise depend on a range of interconnected social, environmental, and economic factors which, until recently, were often viewed as too remote or speculative to take into account and report. Contemporary interpretations of fiduciary duty have proved ill suited to taking an integrated view of and actively managing them. The fact that they now present systemic risk issues, however, also recalls the precautionary principle – the duty to focus first on *doing no harm* and to take impartial account of the interests of beneficiaries to whom fiduciary obligations are owed when developing an investment approach.³¹ Indeed, a trust fund beneficiary's "first claim is that the fiduciary must refrain from causing harm ... 'Do no harm' is the clarion call of every fiduciary" (Laby 2004, 149).

Loyalty to the interests of beneficiaries may require consideration of and response to their varying views on appropriate levels of risk exposure (including, perhaps, efforts to help inform such views). Ignoring the views of beneficiaries (or the interests of other key stakeholder groups) could have long-term ramifications with respect to support for, and consequently, sustainability of the pension promise. Attentiveness to and management of stakeholder expectations can be as important to sustainable success as investment management decisions.

These considerations (as well as the need to build governance capacity) suggest that trustees should be sensitizing themselves to the interests of beneficiaries (future and present), both directly (i.e., through efforts to consult and to inform) and by looking to evolving universal norms as a proxy therefor (Richardson 2010). This, in turn, requires implementation of processes for engagement that identify and consider externalities associated with management practices.

Application of the duty of loyalty, which mandates that procedures be impartially aligned with participants' interests, also has implications for resolving the *tragedy of the commons*

paradox, wherein fiduciaries reject strategies expected to produce shared benefits while *free-riding* on the efforts of others.³² Fiduciaries cannot simply ignore the interests of a group of beneficiaries because most other fiduciaries are doing the same and are unwilling to pursue cost-effective shared benefits.

Likewise, fiduciary responsibilities require that, in considering the interests of pension participants and beneficiaries, trustees measure and report on success in achieving the fundamental purpose of the pension trust – the provision of an independent mechanism for securing the pension promise and actual performance in so doing.

Incorporating Sustainability Factors into the Investment Management Process

The assumption that risk can be managed solely or primarily through diversification was shown to be flawed by the recent economic crisis. For example, investors cannot avoid the risks associated with climate change by diversifying across asset classes; they must instead seek to diversify across sources of risk (Mercer Consulting 2011). Yet legal uncertainty has led to a view within the investment supply chain that integrating long-term risks and opportunities into the investment process is someone else’s problem.

Signatories to the United Nations Principles of Responsible Investment (UNPRI) have now grown to more than 850 institutional investors with US\$25 trillion under management – a signal that they are beginning to recognize the connections between a commitment to incorporate environmental, social, and governance (ESG) issues into their policies and practices and the fundamental fiduciary duties of loyalty and impartiality. ESG issues that might be of little concern to short-term traders can be material for long-term investors with obligations to manage assets impartially and in the interests of beneficiaries, so as to deliver sustainable pension benefits over several generations.³³

Urwin (2011) has recently described the focus of “universal owners” on investment strategies and ownership practices (including collective action to produce network benefits) that integrate ESG considerations. Moreover, pension funds (along with other significant long-term investors) are uniquely positioned to benefit from investment opportunities that address unmet economic (and social) needs rather than simply investing in existing assets. To do so, fiduciaries need to overcome the tendency to allocate capital based solely on historical practices and approach sustainable investing from a forward-looking, risk management and value creation perspective (World Economic Forum 2011a).

It is also increasingly apparent that regulatory leadership will be required to motivate long-term fiduciaries (and their service providers) to effectively integrate ESG criteria into their investment decision making as part of effective risk management and regulatory compliance. Incentives should be aligned – by mandating appropriate fiduciary competencies, governance, and reporting practices that are designed to deliver sustainable retirement income security. Part of the challenge (again) is to rediscover and operationalize fundamental fiduciary norms, as well as adapt them to an evolving global investment environment.³⁴

Stewardship codes for institutional investors are now in place or being considered in the United Kingdom, Europe, Canada, Australia, and elsewhere. South Africa has taken the lead by introducing, through regulation, several principles to be applied to investment institution fund assets. This includes a mandate that the investors, “before making an investment into and while invested in an asset, consider any factor which may materially affect the sustainable long-term performance of the investment, including those of an environmental, social and governance character.” The preamble to these regulations squarely frames the duty of prudence (and, by implication, impartiality) as including proper consideration of these issues.³⁵

The Way Forward: Development of Key Performance Indicators

Business as usual is not likely to result in pension management practices that are designed to be unbiased and aligned with the interests of participants and beneficiaries; nor is it likely to provide suitable pension benefits on a sustainable and impartial basis. Yet that is the challenge today’s fiduciaries face. We believe that plan sponsors, participants, beneficiaries, fiduciaries, and advisors could benefit from the development of key performance indicators to help guide pension management practices toward measurable success in meeting fundamental fiduciary goals. This article is intended to provoke an industry discussion focusing on that challenge.³⁶

Table 1 provides an initial list of factors for consideration by fiduciaries in working toward the application of their fiduciary duties to contemporary challenges. It provides a starting point for discussing how developments in knowledge and changes in the circumstances faced by pension funds affect fiduciary obligations and practices. Such discussions would help to inform an evolving understanding of fiduciary duties and, in turn, promote success in sustainable delivery of promised pension benefits.

Table 1: Reclaiming Fiduciary Duties – Key Governing Fiduciary Issues

Fiduciary Challenges	Fiduciary Issues: Policies and Procedures	Fiduciary Issues: Oversight Responsibilities
<ul style="list-style-type: none"> • Changing circumstances and knowledge base • Systemic and long-term risk exposures • Inter-generational equity and pension disparity • Unbalanced short-termism • Conflicts of interest • Pension governance quality • Implementation of <i>do no harm</i> principle • Alignment of policies and procedures 	<ul style="list-style-type: none"> • Allocate resources and time to understand challenges • Adopt enterprise risk management approach • Use beneficiary-aligned and impartial measures of success • Understand global best practices • Develop <i>fit for purpose</i> governance capabilities • Ensure sustainable plan design • Expand reporting / engagement to address loyalty and impartiality 	<ul style="list-style-type: none"> • Acquire expertise to address fiduciary challenges • RFPs to address fiduciary challenges • Invest in research on long-term issues and fiduciary challenges • Foster collaboration on education and shared resource development • Measure success impartially on achieving beneficiary goals and interests • Identify and measure risks across all beneficiary groups • Align service provider contracts and fees with beneficiary interests • Manage ESG risks and opportunities for sustainability and impartiality

Endnotes

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2. In the United Kingdom, 73% of defined benefit plans are now closed to new entrants.
3. See also New York Stock Exchange website, http://www.nyxdata.com/nyse-data/asp/factbook/viewer_edition.asp?mode=table&key=2992&category=3.
4. The long-term value destruction dynamic is illustrated in a study by Bhojraj et al. (2009), who found that companies which use reductions in R&D, advertising, and other discretionary spending to narrowly beat Wall Street quarterly projections experience a short-term stock value increase but go on to underperform over the following three years.
5. See, for example, Montgomery (2011); Kahneman and Tversky (1979); and Devenow and Welch (1996).
6. See, for example, J.P. Morgan Asset Management (2009); and Taleb (2007). A good example of this is the “pack mentality” of hedge funds (correlations of returns) from 2004 to 2010: see, for example, Strasburg and Pulliam (2011).
7. The popularity of index funds had an unpredicted consequence, which illustrates the *fallacy of composition* problem, one manifestation of which is herding. As a result of increase in demand for stocks that are included in a market index, the price of these stocks has been moved to some extent independently from their fundamental values. The indexation paradox has led to undermining the efficacy of the risk metrics essential to calculating risk-adjusted returns, since, paradoxically, a market index is no longer representative of a market; rather, it fluctuates based on the demand of index funds and portfolio managers that attempt to replicate the index. Therefore, performance evaluation based on these indices (both alpha and beta) is subject to inefficiencies, as these indices are not really an “index” of the market.
8. Indeed, Keynes’s mid-1930s observation about the dangers of unrealistic economic assumptions is just as relevant today: “Too large a proportion of recent ‘mathematical’ economics are mere concoctions, as imprecise as the initial assumptions they rest on, which allow the author to lose sight of the complexities and interdependencies of the real world in a maze of pretentious and unhelpful symbols” (Keynes 1936, 298).
9. Different forms of pension organizations, governing structures, and legal regimes may require varying approaches to implementation of an evolving understanding of fiduciary duty. For example, changed regulations or stricter enforcement of existing laws might be appropriate in some civil law jurisdictions, while supervisory authorities or courts might adopt new interpretations of existing legal principles in some common law jurisdictions. Even under common law tradition, pension law is a unique combination of trust and contract principles that is effectively a specialized form of contract law (see Langbein 1997). See also Stewart and Antolin (2008) and Galler (2002) for a discussion of the fundamental pension fund governance issues that are common across various legal structures and jurisdictions.
10. Ironically, some recent regulatory reforms are moving toward a revival of constraints on permissible assets (and asset classes) in response to funds taking outsized risks to remedy their deficits; see, for example, Norgrove (2010).
11. See Restatement of Trusts, Second (1959), §227, Comment (f).
12. See, for example, National Conference of Commissioners on Uniform State Laws (1997a).
13. See, for example, Nelson (1993); Stanley (1984).
14. For a discussion of key fiduciary duty concepts across various jurisdictions see Berry (2011).
15. National Conference of Commissioners on Uniform State Laws (1997a); Restatement of Trusts, Third (1992, §227). Similar principles apply across common law countries (e.g., Canada, the United States, the United Kingdom, Ireland, Australia) and civil law countries (e.g., Italy, Japan, the Netherlands) (Galler 2002).
16. While this paper does not focus on defined contribution (DC) pension plans, the same basic legal responsibilities of trustees (including loyalty and impartiality) apply to selection and monitoring of investment options by the fiduciary, even though participants decide on allocation of their own savings between managers. See *Howell v. Motorola* (2011).
17. “[The] issues with respect to typical trusts ... are materially different from those in the corporate-governance discussion, and trust beneficiaries ordinarily have available no close counterpart of the corporate shareholders’ opportunities to sell their stock or to influence their company’s behavior” (Restatement of Trusts, Third, 1992, §227, Comment (c)). For example, trust law generally precludes fiduciaries from engaging in self-interested transactions, although corporate directors can usually enter into related-party transactions with the company if these are disclosed and approved by disinterested directors as fair to the corporation. See Restatement of Trusts, Third (1992, §8 and §144).
18. It is worth noting that courts have extended pension fiduciary liability. For example, in two related cases, the Ontario Divisional Court imposed a fiduciary liability on the (then) Pension Commission of Ontario for consenting to the withdrawal of surplus funds without giving notice to plan members. See *Re Reeve and Montreal Trust Co. of Canada* (1996) and *Re Collins and Pension Commission of Ontario* (1986).
19. In the United States, pension funds subject to the *Employees’ Retirement Income Security Act*, 29 USC §18.1104, must be managed “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”
20. *Merriam-Webster Dictionary* (2011), s.v. “prudent.”
21. Drucker’s focus on “wealth-creating” investment traces its roots to Keynes (1936).
22. The United States Supreme Court, in *Varity v. Howe* (1996), stated that “the common law of trusts [made applicable to ERISA §§404, 409] recognizes the need to preserve assets to satisfy future, as well as present, claims and requires a trustee to take impartial account of the interest of all beneficiaries.”

Endnotes (cont'd)

23. Restatement of Trusts, Third (1992), Comment (c) to §79(1). In the United Kingdom, the 1984 case of *Cowan v. Scargill* turned on impartiality. See also *Withers v. Teachers' Retirement System* (1978, 1257–58). The CFA Institute's Code of Conduct for Members of a Pension Scheme Governing Body advises that an effective trustee will "consider the different types of beneficiaries relevant to each pension scheme" and "engage in a delicate balancing act of taking sufficient risk to generate long-term returns high enough to support real benefit increases for active participants who will become future beneficiaries while avoiding a level of risk that jeopardizes the safety of the payments to existing pensioners" (Schacht and Stokes 2008).
24. Similarly, article 5, paragraph 4, of the Dutch *Pension and Savings Fund Act* (1997) provides that "in performing their duties, the persons who determine or help determine the policy of a pension or savings fund shall act in accordance with the interests of the members, former members and other stakeholders involved in the fund." The legislative history of the Act makes it clear that participants must be represented in a balanced way, with an eye to the possibly divergent interests of the various categories of stakeholder: members, dormant members, pensioners, and other stakeholders (see Maatman 2004).
25. For example, more than 73% of British defined benefit plans are closed to new entrants. In 2009, only 49% of the 200 largest American companies had ongoing defined benefit plans, down from 61% three years earlier (Yermo and Severinson 2010; see also Mercer Consulting 2011).
26. In Europe, article 18, paragraph 1, of the *EU Pensions Directive* (Directive 2003/4 ED) provides that member states must observe the "solely in the interest rule," which requires that assets be invested in the interests of fund members and beneficiaries; in the event of a conflict with other stakeholders, their interests must prevail.
27. There has been a tendency to mistakenly conflate the obligation to manage trust assets in the interest of beneficiaries with the other aspects of the duty of loyalty, which require that assets be managed impartially and for the purpose of providing pension benefits. However, these different aspects of loyalty are distinct obligations. Pension management activities can be designed solely to produce pension benefits yet still violate the duty of impartiality and not be in the interest of all beneficiaries. For example, pursuit of investment activities designed to produce short-term returns while generating long-term risks to pension sustainability may pass the "sole purpose" test but violate the "interest of beneficiaries" and "impartiality" fiduciary duties.
28. For more insight into the critical role of Board leadership see Clark and Urwin (2008a, 2008b).
29. Viewing delegated responsibilities as carrying with them fiduciary obligations might also strengthen the view of such delegation as a fiduciary function.
30. "Viewed from the beneficiaries' perspective, especially that of remainder [long-term] beneficiaries, efforts to prevent or detect actual improprieties can be expected to be inefficient if not ineffective" (Restatement of Trusts, Third, 1992, §78, Comment (b)).
31. See, for example, *CFSIEFF & ORS v. Fox & ORS* (2005). Canadian courts have developed this concept, as well as the "duty to consult," in the context of governments contemplating conduct that might adversely affect the rights of Aboriginal peoples (see, e.g., Lawrence and Macklem 2000).
32. *Free-riding* occurs when a shared resource or benefit is used without users' paying the full cost of it. Over time, this typically leads to overconsumption or exhaustion of the resource or to under-provision of it.
33. The duties to manage pension assets (a) solely in the interest of pension plan participants and beneficiaries, (b) for the exclusive purpose of providing benefits, and (c) with impartiality are separate components of the duty of loyalty. Sustainable investment practices recognize that an investment can be made for the purpose of generating income for benefits yet still not meet fiduciary standards if it does not also qualify as impartial and in the interests of participants and beneficiaries.
34. See also International Organization for Standardization (2010, clause 2.18), which defines *social responsibility* as the "responsibility of an organization for the impacts of its decisions and activities on society and the environment, through transparent and ethical behaviour that (i) contributes to sustainable development, including health and welfare of society, (ii) takes into account the expectations of stakeholders, (iii) is in compliance with international norms of behaviour; and (iv) is integrated throughout the organization and practiced in its relationships."
35. Pension Funds Act, 1956 (South Africa): Amendment of Regulation 28 of the Regulations made under Section 36, preamble and Section 1(b)(viii) (February 23, 2011).
36. With support of a research funding grant from the Rotman International Centre for Pension Management, the authors plan to hold fiduciary roundtables to explore development of key performance indicators and publish the findings in future articles.

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