

# **SCOTT + SCOTT, LLC**

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## **Fiduciary Duties: Evolving Into The 21st Century**

# Who Is A Fiduciary

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## Primary Fiduciaries

Common Law Jurisdictions (U.K./U.S.): Board of Trustees

Civil Law Jurisdictions: Pension Scheme Management Committee

## Others With Duties Similar To Fiduciaries

Asset Managers, Actuaries, Pension Consultants

# Common Law Fiduciary and The Fiduciary Duties Owed



## Common Law Jurisdictions

Source of Law

Statutes & Case Law

Two Primary  
Fiduciary Duties

**Duty of loyalty: all investment decisions must be motivated by the interests of the scheme's beneficiaries and/or the scheme's purpose.**

**Duty to act prudently: exercise reasonable care, skill & caution in pursuing an overall investment strategy with due regard to scheme's risk & return objectives.**

# Civil Law Fiduciary and The Fiduciary Duties Owed



## Civil Law Jurisdictions

Source of Law

Statutes & Code

Fiduciary  
Duties

Duty to act in best interests of the beneficiaries.

Duty to seek profitability (although no level of “profitability” is prescribed).

Duty to diversify, either explicitly or implicitly required.

Other duties regarding liquidity & permissible asset classes.

# Overview of Common Law Fiduciary Duties and Sources of those Duties



U.K.	U.S.
<b>Duties Imposed on Trustees</b>	
<ul style="list-style-type: none"> <li>•Duty of loyalty                             <ul style="list-style-type: none"> <li>-- Act in the sole best interest of the beneficiaries</li> <li>-- Act in accordance with the terms of the trust</li> </ul> </li> <li>•Duty to act prudently                             <ul style="list-style-type: none"> <li>-- Diversify</li> <li>-- Act with reasonable care, skill &amp; diligence in overall investment strategy</li> </ul> </li> </ul>	
<b>Sources of Law</b>	
<ul style="list-style-type: none"> <li>•Pensions Act of 1995</li> <li>•The Occupational Pension Schemes (Investment) Regulations 1996</li> <li>•Pensions Act of 2004 and The Occupational Pension Schemes (Investment) Regulations 2005</li> </ul>	<ul style="list-style-type: none"> <li>• Employee Retirement Income Security Act of 1974 (ERISA)</li> <li>•State law on fiduciary duties and conflicts of interest</li> </ul>

# Overview of Civil Law Fiduciary Duties and Sources of those Duties



France (FRR)	Germany	Switzerland
<b>Duties Imposed On Pension Scheme Managers</b>		
<ul style="list-style-type: none"> <li>•Ensure profitability by maximizing investment returns</li> <li>•Act prudently</li> <li>•Ensure diversification</li> <li>•Contribute to best practice</li> </ul>	<ul style="list-style-type: none"> <li>•Ensure the highest possible security and sustainable profit</li> <li>•Ensure diversification &amp; liquidity</li> <li>•Act prudently in managing investments</li> <li>•Disclose information regarding ESG investment policies</li> </ul>	<ul style="list-style-type: none"> <li>•Carefully choose, manage &amp; control its investments</li> <li>•Ensure safety of funds, adequate returns &amp; diversification of risk</li> </ul>
<b>Sources of Law</b>		
<ul style="list-style-type: none"> <li>•French social security code</li> <li>•Law n° 2001-624 (amended by the law n° 2003-775)</li> <li>•Decree n° 2001-1214</li> </ul>	<ul style="list-style-type: none"> <li>•Insurance Supervision Act (Versicherungsaufsichtsgesetz, VAG)</li> <li>•Pension Fund Investment decreelaw (Pensionsfonds-KapitalanlageVO, PFKapAV)</li> </ul>	<ul style="list-style-type: none"> <li>•LPP / BVG</li> <li>•OPP 2 / BVV 2</li> </ul>

# Evolving Fiduciary Duties: Prudence



**Late 19th/Early 20th Century:** Trustees only concern with corpus & obtaining reasonable income; bonds acceptable investment, but common stock prohibited

**1950s:** Emergence of Modern Portfolio Theory -- risk minimization through diversification & evaluation of assets in the context of overall portfolio holdings

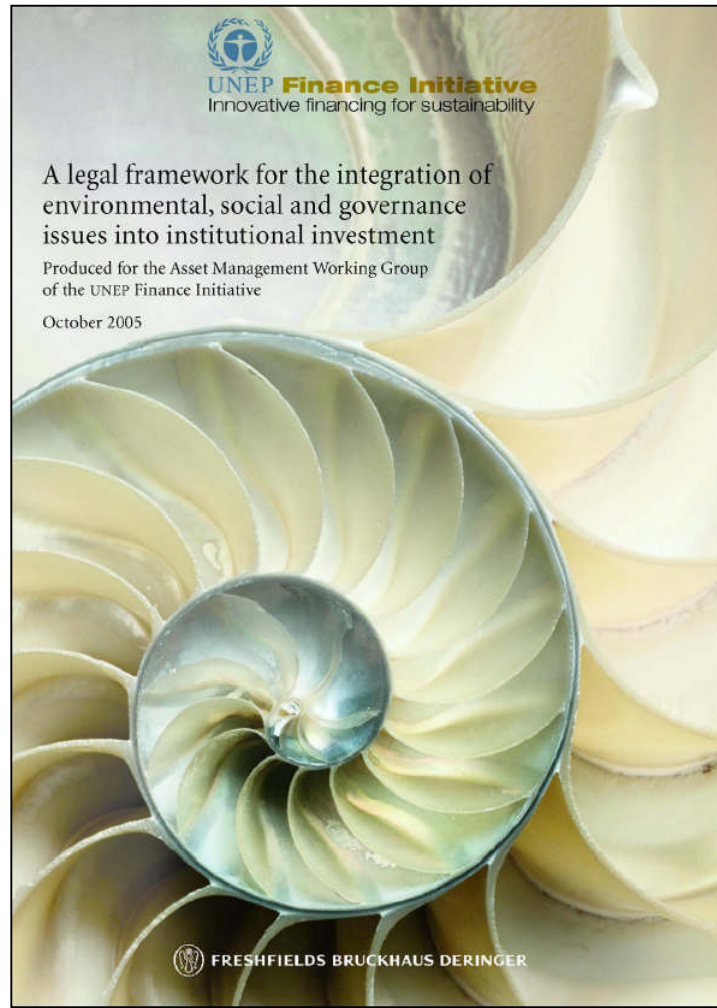
**1970s:** Modern Portfolio Theory at odds with trust law, which was stuck in 19th century and was overly restrictive & tied the hands of trustees

**1976:** Model Portfolio Theory incorporated into ERISA standard of prudence

**1990s:** American Law Institute with Restatement (Third) of Trusts: trust investment law should reflect current knowledge & concepts in the financial community

**Today:** Financial world has learned that ESG can drive better financial performance, thus fiduciary duties/prudent investor rule must reflect that

# Evolving Fiduciary Duties Widely Recognized



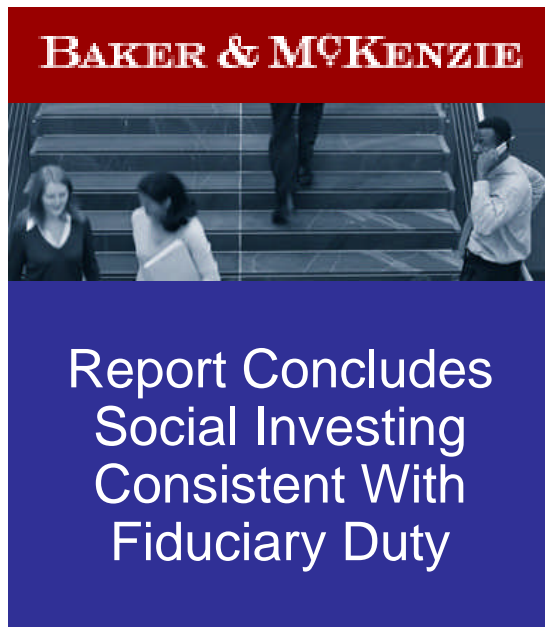
*Cowan v. Scargill* is “misunderstood” and at most “may be treated as endorsing the accepted rule that trustees exercising fiduciary investment powers must exercise those powers for the purpose for which they were granted.”

## CONCLUSION

Integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions.

# Evolving Fiduciary Duties Widely Recognized

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- Considering ESG factors is consistent with trustee fiduciary responsibility, so long as trustees follow their legal mandate to maximize returns at the same time.
- Fiduciary duties of loyalty & prudence obligates trustees to at least consider ESG factors because those factors do impact risk/return calculations.
- U.S. Department of Labor clearly establishes the legality of pension funds actively voting proxies, holding SRI funds, and conducting shareowner action.

# Evolving Fiduciary Duties Widely Recognized

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- Norway's Ethical Guidelines govern the administration of the Government Pension Fund – Global, which are based on two premises:
  - The Fund must be managed so as to generate a sound return in the long term, which is contingent on sustainable development in the economic, environmental and social sense.
  - The Fund should not make investments which constitute an unacceptable risk that the Fund may contribute to unethical acts or omissions, such as violations humanitarian principles, human rights, gross corruption or environmental damages.
- January 2006, on the basis of these Ethical Guidelines, Norway excluded seven companies from the Government Pension Fund - Global because they are involved in production of nuclear weapons.

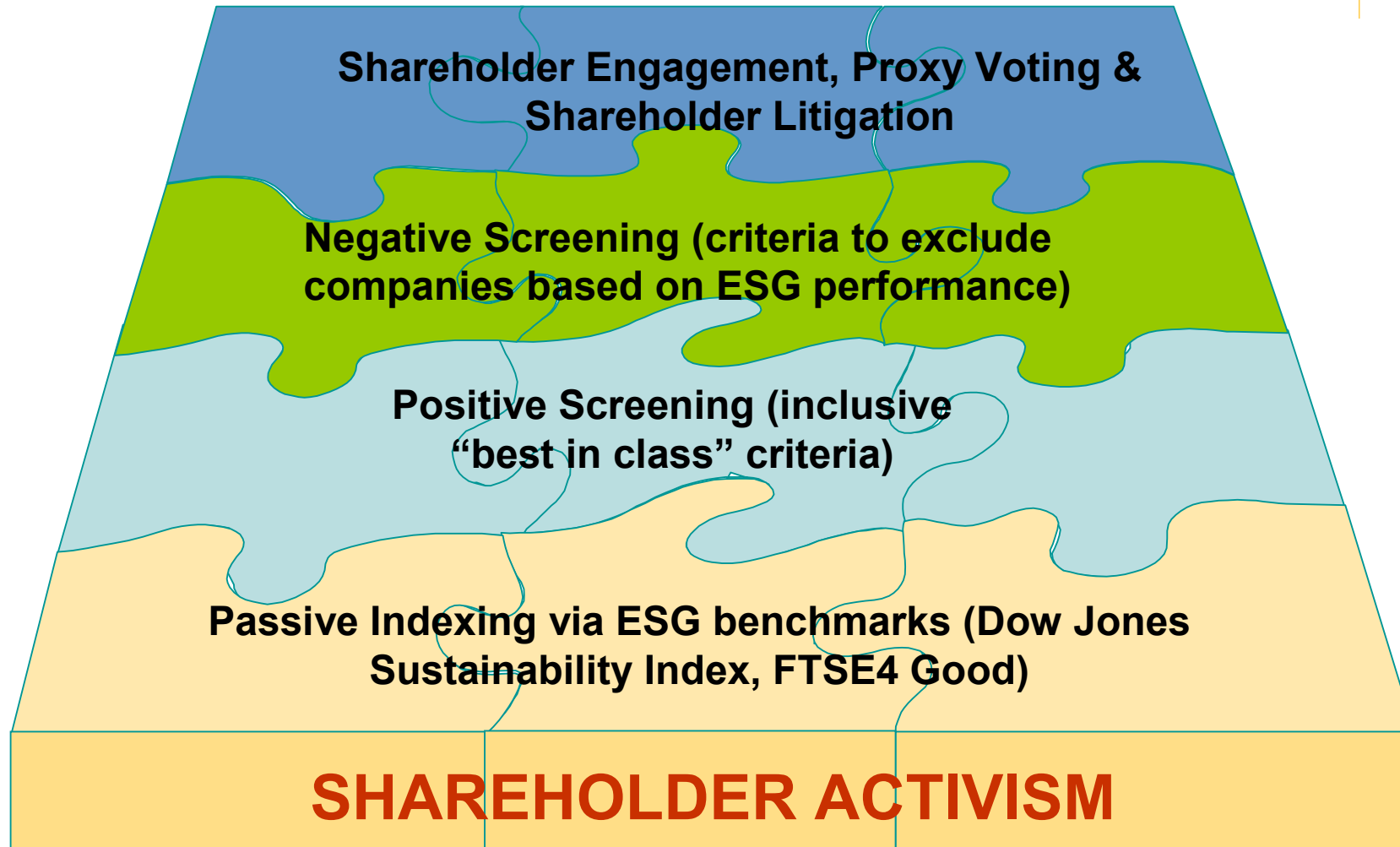
# Fiduciary Duties In The 21<sup>st</sup> Century: What Does It Mean?

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- 21st century fiduciary responsibility requires consideration of the social, environmental, political, and cultural effects of investments, both positive and negative, over the short and long term as a fundamental part of the investment process.
- This is a financial issue that identifies risks & opportunities not captured by conventional financial analysis.
- With ESG factors clearly impacting companies' risk/return profiles, fiduciaries are increasingly viewed as "derelict in their responsibilities if they do *not* take them into account," according to Matthew Kiernan, CEO of SRI research firm Innovest Strategic Value Advisors.

# Evolving Fiduciary Duties Include Shareholder Activism



# Fiduciary Duties & Conflicts of Interest: Case Studies

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## Breach Of Fiduciary Duty In Practice – 3 Scenarios

- **San Diego: The Enron By The Sea**

San Diego City Employees Retirement System trustees systematically increased benefits, while decreasing contributions to the pension system.

- **General Motors: Violation Of The Prudent Investor Rule**

GM 401(k) trustees imprudently recommended company stock for employee retirement funds.

- **Mutual Funds: Failure to Collect Funds**

Large U.S. mutual funds sued for breaches of fiduciary duty in failing to collect on settlements in securities class action litigation.

# San Diego: The Enron By The Sea

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- City funds pension through contributions.
- The Board administers pension to ensure it can pay current & future benefits.
- City pressured Board to approve reduced contributions without regard to the impact on the financial soundness of the pension system.

# San Diego: The Enron By The Sea

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## Trustees Breached Their Fiduciary Duties By:

- Allowing the City to pay less than actuarially required in exchange for increased employee and retiree benefits—including increases in benefits to a majority of the pension trustees, who were also City employees.
- Allowing the City to establish several new employee benefits even though imprudent to do so, which allowed senior employees, including some trustees, to start drawing pension checks up to five years before they actually retired.
- Failing to disclose that as a result pension under funding the would be forced to make a payment of approximately \$150 million, which the city couldn't afford.
- Allowing the City to publish and circulate outdated and incorrect information about the city's funding of the retirement system in a city bond document which may amount to securities fraud.
- In sum, instead of acting with the beneficiaries' best interests in mind, the Board breached its fiduciary duties when they made considerations solely with an eye toward saving the City money.

# San Diego: The Enron by the Sea



Former U.S. Securities & Exchange Commission Chairman, Arthur Levitt, Jr., concluded in his investigative report:

“... San Diego City officials fell prey to the same type of corruption of financial management and reporting that afflicted ... such private sector companies as Enron [and] HealthSouth ... San Diego officials cultivated and accepted a culture of financial management and reporting premised on non-transparency, obfuscation, and denial of fiscal reality.”

Source: Report of the Audit Committee of the City of San Diego at 3 (Aug. 8, 2006).

## RESULT OF BREACHES OF FIDUCIARY DUTY

- City saddled with \$1.4 billion in unfunded pension liabilities by systematically over-promising on benefits & short-changing the pension on contributions.
- Six former trustees have been brought up on civil & criminal charges.
- Pension system is embroiled in litigation over the legitimacy of the benefits approved by trustees in breach of their fiduciary duties.

# General Motors: Violation Of The Prudent Investor Rule

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- By 2005, GM's business was not performing nearly as well as represented to the investing public & retirement plan beneficiaries.
  - GM used improper accounting to understate its pension & healthcare obligations & overstate the extent to which these were fully funded.
  - GM's financial condition had deteriorated to the point where GM's credit rating was being downgraded to junk status.
  - GM's financial condition also had deteriorated so that it needed to revise its first-quarter and 2005 calendar year earnings guidance.

# General Motors: Violation Of The Prudent Investor Rule

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## GM Retirement Plan Trustees Breached Their Fiduciary Duties By:

- Failing to discontinue GM stock as an investment option in GM's retirement plans, thereby breaching their duty of loyalty to Plan beneficiaries. To do so would have been an immediate signal to the market that GM was in trouble.
- Negligently allowing the Plans to purchase & hold General Motors stock when it was imprudent to do so.
- Negligently misrepresenting & failing to disclose material facts regarding the management of Plans' assets.
- Failing to adequately monitor the Plans' other fiduciaries.



# An Open Question For 21st Century Fiduciaries

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**Is it a breach of fiduciary duty for a trustee or pension manager to allow scheme assets to be invested in non-sustainable companies (e.g. companies causing climate risk)?**

- Climate change is a serious concern that presents risks & opportunities to investors.
- Fiduciaries have legal authority & may well have an obligation to address climate risk. Many pension funds are already acting to analyze the issue, raise awareness & press for disclosure for improved corporate strategies to address climate risk.
- Connecticut State Law asserts that public pension fund fiduciaries may consider environmental implications of investments, including decisions related to individual securities or types of securities. C.G.S 3-13(d)(2002)

# An Open Question For 21st Century Fiduciaries

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- **Duty of Obedience:**

- Requires fiduciaries to consider whether investment decision would further, or at least not hinder, the fulfillment of the scheme's purpose.
- Clear for non-profits: mission statement clearly articulated.
- Less clear for public pension schemes.
- ERISA requires trustees to invest “to further the purpose of the plan.”
- Where the purpose is to provide retirement to beneficiaries, factors such as climate change may affect the markets in which the scheme is invested, and thus may be contrary to the overall health of the scheme and its beneficiaries.

# CONCLUSION

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Activist pension schemes have focused on the corporate governance standards of the companies in which they invest.

Pension trustees & managers now should apply those same standards to the governance of their pension scheme to ensure compliance with fiduciary duties given how those duties are evolving.