Cambridge Handbook of Institutional Investment and Fiduciary Duty

The *Cambridge Handbook of Institutional Investment and Fiduciary Duty* is a comprehensive reference work exploring recent changes and future trends in the principles that govern institutional investors and fiduciaries. A wide range of contributors offer new perspectives on dynamics that drive the current emphasis on short-term investment returns. Moreover, they analyze the forces at work in markets around the world which are bringing into sharper focus the systemic effects that investment practices have on the long-term stability of the economy and the interests of beneficiaries in financial, social and environmental sustainability. This volume provides a global and multifaceted commentary on the evolving standards governing institutional investment, offering guidance for students, researchers and policymakers interested in finance, governance and other aspects of the contemporary investment world. It also provides investment, business, financial media and legal professionals with the tools they need to better understand and respond to new financial market challenges of the twenty-first century.

JAMES P. HAWLEY is Professor and Senior Research Fellow of the Elfenworks Center for Responsible Business at Saint Mary's College of California. He is the author (or co-author) of well over thirty scholarly articles, as well as four books, on a variety of topics, including corporate governance, responsible investment, the international monetary and financial system, and environmental issues.

ANDREAS G. F. HOEPNER is an Associate Professor of Finance at the ICMA Centre of Henley Business School at the University of Reading, where he directs the i-finance laboratory. He is also currently serving as the Senior Academic Fellow to the United Nations supported Principles for Responsible Investment and as Senior Associate to the University of Cambridge's Programme for Sustainability Leadership.

KEITH L. JOHNSON represents pension funds and institutional investors globally on fiduciary, investment, corporate governance and related litigation matters. He chairs the Institutional Investor Services Group at Reinhart Boerner Van Deuren, s.c. He is also co-chair of the Fiduciary Duty Working Group for the Network for Sustainable Financial Markets, an international think-tank.

JOAKIM SANDBERG is Associate Professor of Practical Philosophy at the University of Gothenburg, Sweden. He is an internationally acclaimed expert on ethical issues in finance in general and also in pension management. His PhD work (from 2008) was the first ever comprehensive philosophical treatment of the concept of socially responsible investment.

EDWARD J. WAITZER is a Professor and the Jarislowsky Dimma Mooney Chair in Corporate Governance at Osgoode Hall and the Schulich School of Business at York University. He was Chair of Stikeman Elliott LLP from 1999 to 2006 and remains a senior partner whose practice focuses on complex business transactions. He also advises on a range of public policy and governance matters.

When people agree to become members of boards of pension organizations, what duties do they take on? This new book on fiduciary duty makes clear there is no simple answer to this question. It examines the subject not just from a legal perspective, but also from its implications for board behavior, investment policy, and the consideration of societal issues beyond the immediate confines of the pension plan. [It is] a valuable new tool for trustees.

Keith Ambachtsheer

Director of the International Centre for Pension Management at the Rotman School of Management, University of Toronto

Eight years after the Freshfields report, this handbook is a much needed in-depth analysis of the fiduciary duty of institutional investors. It is sharp, thoughtful and inspiring, and takes an interdisciplinary approach, ranging from finance, investment and law to philosophy and psychology. It is a must read for institutional investors wishing to understand and fulfil their fiduciary duties in a modern era.

James Gifford

Executive director of the United Nations-backed Principles for Responsible Investment

A focus on fiduciary standards in the investment chain is critical to the reform of the financial services sector to meet more effectively the needs of the non-financial economy. This book places the issue where it needs to be – on the centre of the stage.

John Kay

Professor at London School of Economics, journalist, and author of The Kay Review of UK Equity Markets and Long-Term Decision Making

This book is a thrice-blessed treasure: it meets society's needs to understand how the eclipse of fiduciary precepts has impoverished our commercial life; it meets the needs of governance professionals in providing a single repository of scholarly analysis of the various aspects of fiduciary duty; and it meets the needs of everyday citizens in describing a world in which their expectations can reasonably be met. It is the right book at the right time by the right people. Congratulations to the Cambridge University Press and the Editors for timely bringing to the public such an essential contribution to public discourse – this book is instantly the must have for all who are interested in corporate governance or who invest money on behalf of others. The authors of the 36 component articles are such a luminous lot that one should not single out individual contributions. In brief, this is an instant classic – no finance or governance library should be without it.

Robert A. G. Monks

Author, entrepreneur, governance expert and former US pension and welfare benefits regulator

Fiduciary principles are under enormous pressure to narrow their reach; at the same moment in history forces shifting the ownership of assets from individuals to institutions argue for greater fiduciary scrutiny of investment decisions. By any measure, the importance of fiduciary principles has never been greater [than now]. The essays set forth in the Handbook are timely and deserving of becoming the intellectual North Star as the discussion of this centuries-old doctrine proceeds.

Knut A. Rostad

Founder and president, Institute for the Fiduciary Standard

This groundbreaking handbook is an insightful look into the real-world challenges of an investment industry navigating the ever-changing waters of the global economy. It shines a light on the risks that fiduciaries may face if they don't understand how the world is changing around them. The handbook is a must read for any investment fiduciary interested in a comprehensive interdisciplinary perspective.

Anne Stausboll

Chief executive officer of the California Public Employees' Retirement System (CalPERS)

Cambridge Handbook of Institutional Investment and Fiduciary Duty

Edited by

JAMES P. HAWLEY

ANDREAS G. F. HOEPNER

KEITH L. JOHNSON

JOAKIM SANDBERG

EDWARD J. WAITZER

CAMBRIDGE
UNIVERSITY PRESS

CAMBRIDGE
UNIVERSITY PRESS

University Printing House, Cambridge CB2 8BS, United Kingdom

Published in the United States of America by Cambridge University Press, New York

Cambridge University Press is part of the University of Cambridge.

It furthers the University's mission by disseminating knowledge in the pursuit of education, learning and research at the highest international levels of excellence.

www.cambridge.org
Information on this title: www.cambridge.org/9781107035874

First published 2014

Printed in the United Kingdom by Clays, St Ives plc

A catalogue record for this publication is available from the British Library

Library of Congress Cataloguing in Publication data
Cambridge handbook of institutional investment and fiduciary duty / edited by James P. Hawley, Andreas G. F. Hoepner, Keith L. Johnson, Joakim Sandberg, Edward J. Waitzer.
pages cm
Includes bibliographical references and index.
ISBN 978-1-107-03587-4 (hardback)
1. Institutional investments. 2. Trusts and trustees. I. Hawley, James P., 1944–
HG4521.C257 2014
658.15′5–dc23
2013046225

ISBN 978-1-107-03587-4 Hardback

Cambridge University Press
978-1-107-03587-4 - Cambridge Handbook of Institutional Investment and Fiduciary Duty
Edited by James P. Hawley, Andreas G. F. Hoepner, Keith L. Johnson, Joakim Sandberg and Edward J. Waitzer
Frontmatter
More information

Contents

Figures

Tables

Contributors

Editors

James P. Hawley Professor and Director, Elfenworks Center for the Study of Fiduciary Capitalism, School of Economics and Business, Saint Mary's College of California.

Andreas G. F. Hoepner Associate Professor of Finance, ICMA Centre, Henley Business School, University of Reading; Senior Academic Fellow, Principles for Responsible Investment, United Nations.

Keith L. Johnson Head of Institutional Investor Legal Services, Reinhart Boerner Van Deuren s.c.; Program Director, Wisconsin International Corporate Governance Initiative, University of Wisconsin Law School.

Joakim Sandberg Associate Professor of Practical Philosophy, University of Gothenburg.

Edward J. Waitzer Professor, Jarislowsky Dimma Mooney Chair in Corporate Governance, Director of the Hennick Centre for Business and Law, Osgoode Hall Law School and Schulich School of Business; Partner, Stikeman Elliott LLP.

Contributors

Jane Ambachtsheer Partner and Global Head of Responsible Investment, Mercer, Toronto; Adjunct Professor, Centre for Environment, University of Toronto.

Ralf Barkemeyer Lecturer in Corporate Social Responsibility, Sustainability Research Institute, University of Leeds.

Larry W. Beeferman Director, Pensions and Capital Stewardship Project, Labor and Worklife Program, Harvard Law School.

Aaron Bernstein Senior Research Fellow, Labor and Worklife Program, Harvard Law School.

Christine Berry Former Head of Policy and Research, ShareAction.

Anders Biel Professor of Psychology, University of Gothenburg.

Tim Cadman University Research Fellow, Institute for Ethics Governance and Law, Griffith University; Research Fellow, Earth Systems Governance Project.

Gordon L. Clark Professor and Director, Smith School of Enterprise and the Environment, University of Oxford; Sir Louis Matheson Distinguished Visiting Professor, Faculty of Business and Economics, Monash University, Melbourne.

Rebecca K. Darr Senior Fellow, Aspen Institute Business & Society Program, New York City; Cofounder of Atayne LLC, Brunswick, Maine.

Stephen M. Davis Associate Director and Senior Fellow, Harvard Law School Programs on Corporate Governance and Institutional Investors; Nonresident Senior Fellow in Governance Studies, the Brookings Institution.

Ivan Diaz-Rainey Senior Lecturer in Finance, Department of Accountancy and Finance, University of Otago.

Robert G. Eccles Professor of Management Practice, Harvard Business School.

Arman Eshraghi Postdoctoral Fellow in Finance, University of Edinburgh Business School.

Frank Figge Professor of Sustainable Development and Corporate Social Responsibility, Kedge Business School, Marseille.

Andrea Finegan Lecturer in Corporate Finance, Norwich Business School and Tyndall Centre for Climate Change Research, University of East Anglia.

Alison Fox Lecturer in Financial Accounting, School of Business, University of Dundee.

Tommy Gärling Emeritus Professor of Psychology, Department of Psychology and Center for Finance, School of Business, Economics and Law, University of Gothenburg.

Dieter Gramlich Professor of Banking, Baden-Wuerttemberg Cooperative State University; Graduate School of Business, Cleveland State University.

Danyelle Guyatt Investment Manager, Catholic Super; Visiting Fellow, University of Bath.

Tobias Hahn Associate Professor for Corporate Sustainability, Kedge Business School, Marseille.

Ian Hamilton PhD Candidate, Umeå School of Business and Economics, Umeå University.

Tessa Hebb Director, Carleton Centre for Community Innovation, Carleton University.

Jock Herron Senior Research Associate and Co-Head of the Digital Cities and Societies Research Initiative, Harvard Graduate School of Design.

Liaw Huang Consulting Actuary, TTerry Consulting LLC, Chicago.

Gbenga Ibikunle Lecturer in Finance and Climate Change, University of Edinburgh Business School.

David Ingram Executive Vice President, Willis Re, New York.

Magnus Jansson Research Fellow, Gothenburg Research Institute, School of Business, Economics and Law, University of Gothenburg.

Michael P. Krzus Founder of Mike Krzus Consulting and co-author, with Robert G. Eccles, of *One Report: Integrated Reporting for a Sustainable Strategy*.

Andrea Liesen Lecturer in Finance, Umeå School of Business and Economics, Umeå University.

Steve Lydenberg Founding Director, Initiative for Responsible Investment; Partner, Strategic Vision, Domini Social Investments.

René H. Maatman Professor of Asset Management, Institute for Financial Law, Radboud University Nijmegen; Partner, De Brauw Blackstone Westbroek, Amsterdam.

Tek Maraseni Deputy Director Operations, Australian Centre for Sustainable Catchments, University of Southern Queensland.

Claire Molinari Visiting Research Associate, University of Oxford.

Agnes L. Neher PhD student in Financial Ethics, Department of Catholic Theology and Business Ethics, University of Hohenheim; Visiting Scholar, School of Management, University of St Andrews.

Jonas Nilsson Assistant Professor of Business Administration, School of Business, Economics and Law, University of Gothenburg.

Gordon Noble Director of Investments and Economy, Association of Superannuation Funds of Australia Ltd.

Michael Perino Dean George W. Matheson Professor of Law, St John's University School of Law, New York.

Ryan Pollice Associate – Responsible Investment, Mercer, Toronto.

Douglas Sarro Law Clerk, Court of Appeal for Ontario.

Charles Scanlan Former Head of Pensions, Simmons & Simmons.

George Serafeim Assistant Professor of Business Administration, Harvard Business School.

Sebastian Siegl Researcher, School of Business and Economics, Åbo Akademi.

Richard Taffler Professor of Finance and Accounting, Warwick Business School, University of Warwick.

Thomas Terry Consulting Actuary, TTerry Consulting LLC, Chicago.

Raj Thamotheram President, Network for Sustainable Financial Markets; Cofounder, Preventable Surprises and the Positive Deviants Club.

Michael Thompson Research Scholar, International Institute for Applied Systems Analysis, Laxenburg, Austria.

Daniel J. Tulloch Doctoral Researcher, Department of Accountancy and Finance, University of Otago.

Roger Urwin Global Head of Investment Content, Towers Watson, London.

Stephen Viederman Grandparent; retired President of the Jessie Smith Noyes Foundation, New York City.

Christopher W. Waddell Senior Attorney, Olson Hagel & Fishburn LLP.

Aidan Ward Organizational Systems Consultant, author of *Trust and Mistrust: Radical Strategies in Business Relationships*.

Christian E. Weller Professor, Department of Public Policy and Public Affairs, University of Massachusetts, Boston; Senior Fellow, Center for American Progress, Washington, DC.

Jay Youngdahl Senior Fellow, Initiative for Responsible Investment, Hauser Center, Harvard University.

Jayne Zanglein Professor of Business Law, Western Carolina University; ERISA attorney, formerly with Vladeck, Waldman, Elias and Engelhard, New York.

Stefan Zeume PhD student in Finance, INSEAD.

Foreword

The world currently faces increasingly complex governance challenges. While there is a growing recognition that we urgently need to take a longer-term view in order to deal with them successfully, many of the incentives that shape the thoughts and actions of leaders encourage myopia in the private and public sectors alike. Strategies with a high probability of success are available but not pursued because powerful short-term incentives are increasingly misaligned with the timeframes required for the solution of growing problems with profoundly destructive inter-generational impacts.

Thus far, legislators have not adequately addressed these inter-generational issues. In previous eras, when obvious and invidious injustices grew to intolerable scale due to the protracted paralysis of leaders, the necessity for action has often found its venue, by default, in the judiciary. Now, once again, courts – responding to specific fact situations – may well play a critical role in breaking this logjam. One likely legal strategy is based on the concept of fiduciary duty – the legal obligation to act in the best interests of others.

With the growth of specialization and interdependence, our increasing reliance on the services and expertise of others has given rise to the concept of a "fiduciary society" – a classic non-zero-sum game in which all can benefit. But if fiduciary obligations are betrayed and trust is eroded, it becomes a game in which all can lose. As a result, the values of *loyalty* and *trust* – shaped by "reasonable expectations" – have come to form the basis for broad fiduciary standards.

These developments have occurred in the context of a historically dramatic change in the ownership of almost all asset classes: public equity and debt, real estate, private equity, infrastructure assets and others. In the past, these types of investments were generally held by individuals. In the last thirty to forty years they have come to be held mostly by institutional investors (e.g., pension funds, mutual and other retirement vehicles) – which, in turn, are fiduciaries for the majority of the adult population. As fiduciaries, they have duties of care and of loyalty which, many are coming to believe, should be extended to encompass attention to inter-generational fairness. In other words, the outcomes of fiduciaries' decisions should reflect due regard for the best interests of future (as well as current) beneficiaries.

Meeting this challenge of fair treatment assumes a level of proficiency with respect to long-term value creation and risk mitigation. Arguably, these fiduciary standards impose obligations:

- To demonstrate respect for social norms;
- to give beneficiaries (or in the case of future beneficiaries, perhaps their proxies) a voice in decisions that affect their interests; and
- to think and act strategically and collectively.

To date, such standards have not been tested in the courts, but there is good reason to believe that they soon will be.

Investing is a means to ensure our future well-being. This requires a broader consideration by fiduciaries of systemic effects – for example, consideration of how investments can create better markets tomorrow, rather than simply focusing on "beating" the market today. Incentives that encourage fiduciaries to take advantage of asymmetries have frequently seduced fiduciaries to succumb to a self-destructive cycle of short-termism and have clearly generated unhealthy outcomes for the system as a whole.

It is only a matter of time before our courts (or regulators) will find opportunities to better define and protect the public interest. This is likely to lead to the imposition of public stewardship responsibilities throughout the financial services supply chain. We see elements of this today in the UK, and in the recent set of "investment beliefs" that CalPERS (the largest public pension fund in the US) recently adopted. Another example is the adoption of Regulation 28 in South Africa that requires that prudent investing should give 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."

Core to the stewardship idea is that human beings are the beneficiaries of their retirement funds. While this sounds obvious to many, far too often the funds themselves (and their relative, benchmarked performance) have been the primary or sole focus of short-term investment strategies. In order to better realize the goals of stewardship, the core concepts of fiduciary obligation will have to be rebalanced. For example, a rebalancing might shift at least some of the weight presently given to "prudence" (often defined as short-term performance relative to "peers") to put greater weight on "loyalty," including a duty of impartiality to current and future beneficiaries.

Those who want to shape the process of fiduciary reform, rather than simply be subject to it, should read this volume of essays. This Handbook highlights the role that fiduciary duty plays in determining how managers of the world's financial capital impact the sustainability of the economy, environment and society, as well as our future financial success.

Those large global financial institutions that are subject to fiduciary duties can and must play a crucial role in solving today's most serious sustainability challenges. This volume brings together some of the leading practitioners, academics and policy makers confronting these issues. We hope and expect many of these ideas and lessons will have significant impact.

Al Gore
Former Vice President of the United States and Co-founder and Chairman of Generation Investment Management