

Introduction to Institutional Investor Fiduciary Duties

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

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Head Office

161 Portage Avenue East, 6th Floor, Winnipeg, Manitoba, Canada R3B 0Y4
Tel: +1 (204) 958-7700 | Fax: +1 (204) 958-7710 | Website: www.iisd.org

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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.

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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.

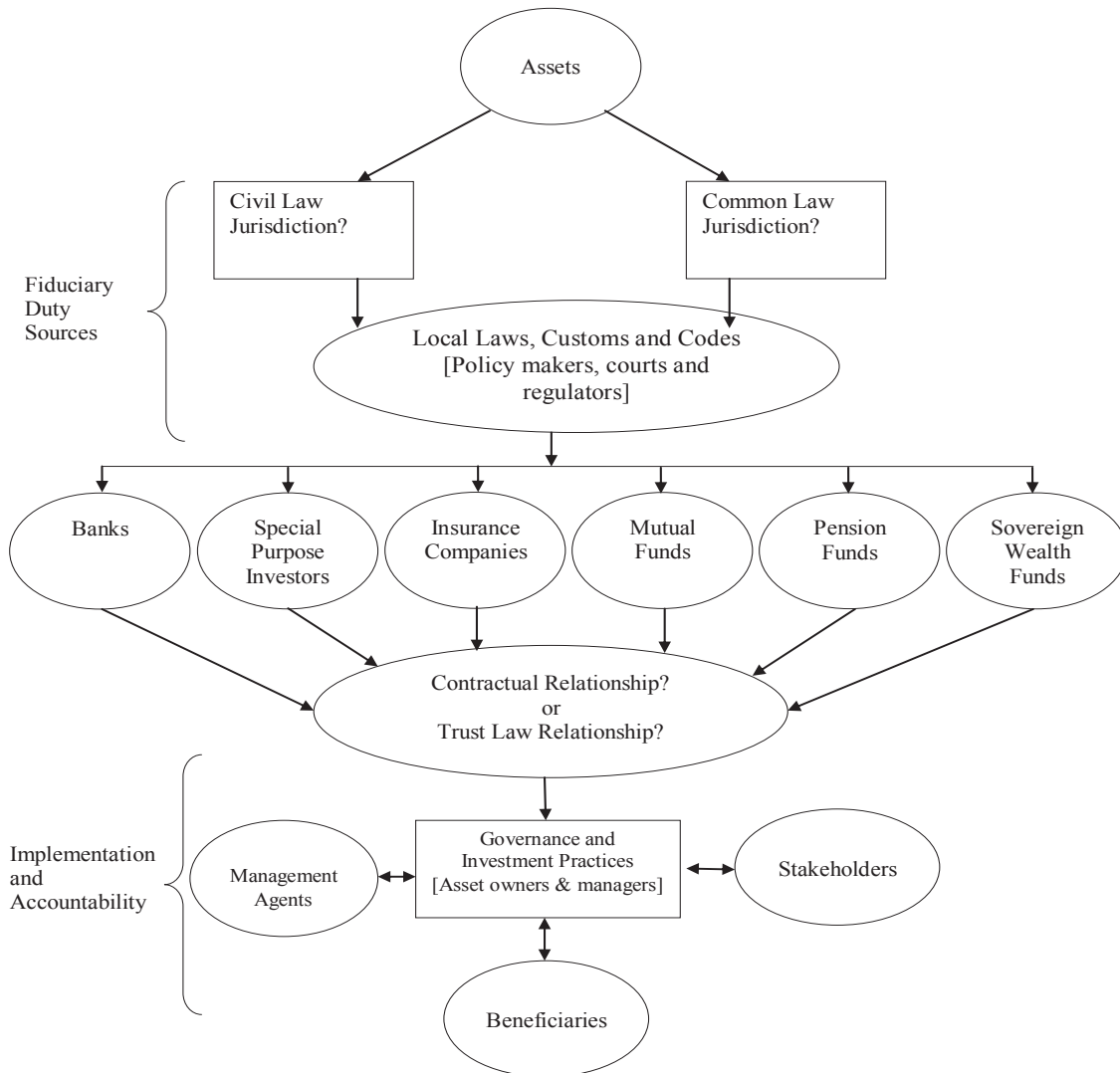


FIGURE 1. FIDUCIARY DUTY AND GOVERNANCE FLOW CHART

“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				
Fish	54	0.09%	287	0.18%
Timber	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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