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"PRUDENT PERSON RULE" STANDARD FOR THE INVESTMENT OF PENSION FUND ASSETS

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"PRUDENT PERSON RULE" STANDARD FOR THE INVESTMENT OF PENSION FUND ASSETS

1. This paper develops work on the investment regulation of pension funds in accordance with the Programmes of Work of the OECD's Insurance Committee and the Working Party on Private Pensions.[1] The manner in which pension fund assets are invested and the way in which that investment is regulated and supervised are crucial to the success of funded pension programmes. The regulation and supervision of pension assets has two main goals: First, to assure the safety and security of those assets and second, to create an environment in which asset management can obtain the best returns at an acceptable level of risk. Additionally and perhaps more controversially, through the regulation of pension asset management, countries may pursue goals exogenous to the health, stability and success of the pension system itself. How best to achieve these goals has been the subject of intense debate in both OECD and non-OECD countries in recent years, especially those that have established or are in the process of establishing funded pension programmes and, in particular, those in which assets are managed by private sector institutions.

2. One key aspect of the policy debate has been whether pension asset management should be regulated by quantitative criteria – i.e., by the establishment of express quantitative limits on the types of assets in which pension funds may be invested – or by the so-called prudent person rule, which is a behaviourally-oriented standard. Although the debate frequently is expressed in terms of these polarised positions, in reality, the regulatory and supervisory environment in many countries is less clear. One can generally observe with some degree of accuracy that OECD countries with an Anglo-American legal tradition have tended to adopt a prudent person rule as their core regulatory mechanism, and other countries have tended to opt for a quantitative limits approach. These characterisations, however, are merely generalisations. Many countries with a prudent person rule in place also have elected to use quantitative limitations – if only to a limited extent and mainly to address conflicts of interest. This is true for instance, in both the United Kingdom and the United States, which are both typically thought of as wholly adopting a prudent person rule method of regulation. Furthermore, Canada is an example of a country that has more substantial quantitative limitations in addition to its prudent person rule, although those limitations have been modified in recent years. Similarly, there are countries that are not associated with Anglo-American law that have adopted a prudent person approach to regulation, such as the Netherlands, Japan and Italy. Finally, some countries in which quantitative limits serve as the core method of regulation also use the prudent person rule – or some similar form of behaviourally-oriented guidance – in addition to the quantitative limitations, thus providing guidance regarding the manner in which investments within each asset class should be made. Evidence of such a mixed approach can be found in

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[1] The Insurance Committee Programme of Work, DAFFE/AS(2001)3, sets forth the goal of surveying and monitoring the implementation of the "prudent-person" principle across OECD Member countries, analysing its major characteristics and related policy issues, and studying the interaction of investment strategies and regulations. Similarly, the Working Party's Programme of Work, DAFFE/AS/PEN(2001)2, identifies the need to review "the functioning of the prudent person approach and its relationship to the governance structure of the pension fund, and the responsibilities and functions of its governing bodies." Related to this item is the Working Party goal of researching the impact of quantitative investment restrictions on the investment performance of pension funds.

some OECD countries[2]. Brazil is an example of a non-OECD country with an occupational, funded pension programme that has been moving in recent years from a stringent quantitative limitations approach to regulation towards a prudent person rule. Despite the mixed approach to regulation taken by many countries, discussion of this issue has taken on an overtly ideological tone. In one sense, however, the debate comes down to the following question: who should be responsible for making the initial, broad determination of an asset allocation policy for a pension fund, the state or each fund's trustees?

3. The debate has been most notably engaged in European Union discussions regarding the development of its directive on "institutions for occupational retirement provision"(IORPs). As approved at the Ministerial level in June 2002, the EU Directive takes a compromised, hybrid approach that enables countries to retain quantitative limitations for domestic pension funds within their borders, and provides a broad, prudent person rule for pan-European funds. Even while embracing the prudent person rule for cross-border activities, however, the directive includes some quantitative boundaries[3].

4. Notwithstanding this active debate about whether a quantitative limitations or prudent person-oriented approach to regulation (or a combination of the two) is the more appropriate, there is insufficient understanding of the precise parameters of the prudent person rule. Because of the nature of the rule, it is not as readily understood as quantitative limitations. Thus, as a preliminary step in fulfilling the OECD's work programme on the investment regulation of pension funds, this paper hopes to contribute to the policy debate with the following discussion of the prudent person rule, focusing on its development and application under UK and US law. Specifically, the discussion proceeds in seven sections that:

1. Set forth an initial definition of the "prudent-person rule," as applied in Anglo-Saxon countries, identifying key characteristics of the rule;
2. Provide historical background on the rule's development;
3. Discuss the rule as applied to pensions in the UK, US and other countries;
4. Review some available research on investment behaviour under the prudent person rule;
5. Identify certain potential prerequisites that may be associated with successful implementation of the rule, such as supervisory monitoring and governance framework;
6. Discuss some of the difficulties in measuring and comparing the investment return of countries that rely on the prudent person rule to those that rely on quantitative regulation; and
7. Recommend potential future work.

I. Prudent Person Rule as Defined in Anglo-Saxon Countries And Key Characteristics

5. Statement of the Rule. The prudent person rule can generally be stated in terms of a broad principle as follows:

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2 For instance, the Polish law establishes prudent person like investment rules within the framework established by overall quantitative limits, based on Articles 29, 139 and 150 of the Law on Organisation and Operation of Pension Funds.

3 European funds will be limited to investing no more than 5% in shares of a single company, 30% in unregulated markets, and 30% in assets denominated in a currency outside the the Eurozone.

A fiduciary must discharge his or her duties with the care, skill, prudence and diligence that a prudent person acting in a like capacity would use in the conduct of an enterprise of like character and aims.

6. Although this paper addresses the rule's application to the investment management of pension assets it applies equally to all of the duties and obligations that a fiduciary or trustee may have with regard to a trust, pension plan or fund.[4]

7. Origin in the Law of Trusts. In Anglo-Saxon jurisdictions, the prudent person rule has its roots in trust law. The "trust" is a concept of Anglo-Saxon law in which an identified group of assets is constituted and managed by trustees for the benefit of another party (the beneficiary). The plan members are beneficiaries of the trust. Outside the Anglo-Saxon legal systems, the trust is less well known, although it does appear in other countries.

8. *Separation of Assets*. The "trust" performs the work of legally separating the assets of the pension plan or fund.[5] Asset segregation protects the assets from being "confused" with those of the trustee, sponsoring employer or financial institution. This requirement thus forces the trustee and other parties to recognise that the plan assets belong to the plan members. The "prudent person rule" is the standard in accordance with which the persons managing the trust – the trustees or fiduciaries – must operate.

9. *Legal Form; Legal Liability.* There is nothing inherently sacred, however, about the trust form. Fiduciary or prudent person standards could be established and applied under different legal forms in countries without a trust concept. Thus, contract law, for instance, may be equally well suited to be the basis for establishing and enforcing a prudent person standard for pension fund officials and investment managers.[6] Indeed, the broader concept of fiduciary obligation can be found outside the area of trusts, arising in a diverse range of relationships, such as agent-principal, director-corporation, guardian-ward, lawyer-client, partner-fellow partner, in addition to trustee-trust beneficiary relationships. The precise scope of a fiduciary's obligation necessarily varies with the context of the relationship. Thus, for instance, trustees are under more stringent restrictions in their dealings with trust property than are corporate

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4 We use the terms "fiduciary" and "trustee" interchangeably throughout the discussion. We also assume for purposes of discussion that persons or entities with discretion in the management of pension plan assets are fiduciaries or trustees to whom the prudent person rule applies; in some jurisdictions, there may be debate about the extent to which certain parties – for instance, third party service providers – acquire fiduciary status in relationship to the activities they undertake on behalf of a trust, plan or fund. Discussion of that issue is beyond the scope of this paper.

5 Legal separation is one of the principles identified in the OECD Basic Principle of Regulation of Private Occupational Pension Schemes, DAFFE/AS/PEN/WD(1999)18/REV3. *See* Principle No. 5. It is also included in the European Commission's proposed directive of the European Parliament and Council on provisions relating to institutions for occupational retirement schemes.

6 Even within the Anglo-Saxon tradition, pension law is a unique combination of combination of trust and contract principles and trust law itself a specialised form of contract law. *See, e.g.,* Langbein, J.H. "The Secret Life of the Trust: The Trust as an Instrument of Commerce" in 107 Yale Law Journal at p. 165-189 (1997) ("[T]he typical trust . . . embodies a contract-like relationship . . . about how the trustee will manage the trust assets and distribute them to the trust beneficiaries. The difference between a trust and a third-party beneficiary contract is largely a lawyer's conceptualism. When, therefore, we enforce a trust . . . we are already in the realm of contract-like behavior.") *and* Gillese, E.E. "Pension Plans and The Law of Trusts" in 75 Canadian Bar Review 221 at p. 250 (1996) ("Pension law . . . . is the intersection of competing systems of law: contract law and trust law.") *Cf.* Millett, L. "Pension schemes and the law of trusts: the tail wagging the dog?" in Trust Law International, V. 14, No. 2 (2000) (reviewing UK law on this issue).

directors in their personal transactions with the corporation.[7] In all these cases, the key elements of the rule are first the nature of the substantive standard of behaviour it sets forth and second, the legal liability to which one is exposed in the event the rule is violated. Although there is a moral component to the rule, (see. E.g. footnote 7), legal liability and its effective enforcement through appropriate administrative and judicial measures is important to the rule's successful implementation.

10. *Common Law Basis of Rule*. The precise parameters of the early form of the prudent person rule were developed in common law via judicial decisions made on a case-by-case basis. In its modern form, the rule is also sometimes expressed in terms of explicit statutory and regulatory language that either conforms to the common law or alters it to better accommodate the practices of contemporary pension funds and modern investment theory and practice. For example, the prudent person rule as applied to pensions in both the United Kingdom and United States is based on the common law, but adapted to the pension environment, primarily in the Pensions Act 1995 (UK) and the Employee Retirement Income Security Act of 1974 ("ERISA") (US). In these instances, however, the judiciary continues to play an important role in defining, interpreting and applying the rule. The UK and US rules are discussed in more detail below at Section III.

11. Although the details of the prudent person rule will vary in expression from country to country, in broad outline it is quite similarly stated in the Anglo-Saxon countries employing it. This is generally a result of its common roots in British common law.

12. *Due Diligence and Process*. The prudent person rule is behaviour-oriented rather than outcome-focused. Thus, a key element of the contemporary version of the prudent person rule is its emphasis on a trustee or fiduciary's performance of due diligence. That is to say, fiduciaries are intended to be judged not by a retrospective assessment of whether their investment decisions were successful, but by whether they followed a reasonable process in reaching their decisions. As one US court succinctly stated, "The focus of the inquiry is how the fiduciary acted in his selection of the investment, and not whether his investments succeeded or failed."[8] As one commentator has more fully explained:

> *"Prudence is to be found principally in the process by which investment strategies are developed, adopted, implemented, and monitored in light of the purposes for which funds are held, invested, and deployed. Prudence is demonstrated by the process through which risk is managed, rather than by the definition of specific risks that are imprudent. Under a modern paradigm, no investment is imprudent per se. The products and techniques of investment are essentially neutral. It is the way in which they are used, and how decisions as to their use are made, that should be examined to determine whether the prudence standard has been met. Even the most aggressive and unconventional investment should meet that standard if arrived at through a sound process, while the most conservative and traditional one may not measure up if a sound process is lacking."*[9]

13. In placing this emphasis on process, the rule thus puts a premium on good fund governance.

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7 "The central preoccupation of fiduciary obligation [is] minimizing potential or incipient conflicts in parties' interests. . . . Some commentators emphasize the characteristics of the fiduciary-beneficiary relationship that may in some situations invite abuse, emphasizing the vulnerability of the beneficiary and the ability of the fiduciary in such situations to indulge his own interest while injurying the beneficiary. This helps to explain the strong prophylactic nature of fiduciary rules, which often seem structured to deter the fiduciary from undertaking particular types of transactions." See DeMott, D. "Beyond Metaphor: An Analysis of Fiduciary Obligation", 1988 Duke Law Journal 881-924.

8 *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983).

9 Longstreth, B. "Modern Investment Management Theory and the Prudent Man Rule" (1986) at p. 7.

14. *Care, Skill, Delegation*. The duty to act prudently imposes a standard of behaviour on a trustee or fiduciary under which he or she must exercise such care and skill as a person of ordinary prudence would exercise in dealing with his own property.[10] It thus assumes and requires of a trustee or fiduciary the necessary level of "familiarity" with the trust, plan, or fund to appropriately carry out responsibilities. From this principle comes the idea that the fiduciary must have or acquire the care and skill sufficient to the tasks for which he or she is responsible. Often this results in the need for the fiduciary to seek and obtain advice from relevant experts and the delegation of various activities to those with the requisite skill. When employing an expert, the fiduciary is responsible for assuring the expert is qualified by adequately investigating the expert's qualifications, and providing the expert with complete and accurate information so that the expert can appropriately formulate requested advice or carry out delegated tasks.

15. *The Duty to Monitor*. Even when delegating responsibilities, fiduciaries remain responsible for monitoring and reviewing the activities delegated to assure that they have been appropriately and prudently carried out. This would include the monitoring and reviewing of investment managers based upon an established investment policy and review procedure.

16. The rule of prudence does not stand alone. It is typically accompanied by additional rules, that some might argue are implicit in the standard of prudence itself. These include the duty of loyalty and the principle of diversification.

- *The Duty of Loyalty*. The duty of loyalty requires the trustee to administer the trust, pension plan or fund solely in the interest of the plan members, often expressed in terms of their "best" interest. In the case of occupational plans, particularly defined benefit plans, because the employer is responsible for funding the plan, the rule is somewhat modified. For instance, the law in the UK requires that pension fund trustees take employer interests into account, for example by requiring trustee consultation with the employer when formulating an investment policy for the pension fund. In the US, the accommodation has been made on a case-by-case via the courts, which have recognised that pension fund fiduciaries also likely are employed by the employer sponsoring the plan and thus "wear two hats." From the duty of loyalty comes the prohibitions on self-dealing in the management of trust assets and on engaging in conflict-of-interest transactions adverse to the interests of plan members. These concepts are often separately and explicitly spelled out in statutes or regulations, but also may be said to be included implicitly in the duty of loyalty itself.[11]

- *The Principle of Diversification*. Another principle associated with the prudent person rule is the principle of diversification. This concept arises from the idea that a fiduciary or trustee should prudently manage assets and avoid undue risk. As noted below, the avoidance of risk was a substantial element of the historical antecedents of the contemporary prudent person

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[10] This aspect of the rule may be expressed in terms of an "ordinary man" or "prudent expert" standard. In the case of the US, the federal pension laws require a fiduciary discharge duties in the manner of 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." ERISA Section 404(a)(1)(B). This is a "prudent expert" standard. By contrast, in the UK, a pension plan trustee is expected to show the skill and prudence of an "ordinary man of business." *See* "Institutional Investment in the United Kingdom: A Review," dated March 6, 2001, referred to throughout this paper as "the Myners' Report", which recommends adoption of a "prudent expert" standard.

[11] These concepts are consistent with OECD principles stating that self-investment should be limited, unless appropriate safeguards exist. *See* Principle No. 11, OECD Basic Principles of Regulation of Private Occupational Pension Schemes, DAFFE/AS/PEN/WD(1999)18/REV3.

rule. The principle of diversification is often stated as an explicit rule, but generally without specific quantitative limitations.[12]

17. As applied to the investment management of plan assets, the duties of prudence, loyalty and diversification are of extreme importance. Without them, there would be solely a broad grant of authority to a fiduciary or trustee to manage pension assets or other trust property with little restraint, guidelines or guideposts. If the principles explained above are understood, and are enforceable and enforced, they have a remarkable ability to corral investment activity into a framework of reasonable behaviour. Indeed, as discussed further below, the rules have significantly curtailed adventurous asset management.

II. Historical Background

18. Historically, the prudent person rule has placed significantly more explicit constraints on trustees and fiduciaries of trusts than the contemporary version of the rule. These antecedents are worth noting, because they are imbedded in the culture of the rule and, thus, continue to colour the interpretation and implementation of the rule today. For example, UK courts continue to look to the common law of trusts in addition to the statutory and regulatory rules specific to pensions.[13] Similarly, in the United States, courts adjudicating pension matters will often refer to the "federal common law" of trusts when interpreting the federal pension laws.

19. The old English rule, which was designed to protect beneficiaries from speculative investments, provided that the only safe (and thus prudent) investment was in government-backed securities, the sole obligation of a trustee being the conservation of principal. In the seminal 1830 case *Harvard College v. Amory*, a US state court set forth a broad prudent person standard that departed from this narrow rule and permitted the investment of trust assets in the stock of private enterprises. The judge in that case, astutely observing that even government bonds carried risk, set forth a standard for trustees that is remarkably similar, yet distinct in important respects, from the contemporary prudent person rule:

> *"All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."*

The rule is similar to – and ultimately serves as the basis of – the contemporary rule in that it embraces both a conduct or process-oriented approach and a duty of loyalty and rejects as inappropriate specific limitations on specific types of investment. It also sets forth a rudimentary concept of risk consistent with the contemporary understanding that all investment decisions come with risk, and therefore, that even a prudently made investment could turn out badly.[14]

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12 The principle of diversification also is included in the OECD principles. *See* Principle No. 11, OECD Basic Principles of Regulation of Private Occupational Pension Schemes, DAFFE/AS/PEN/WD(1999)18/REV3.

13 As one commentator discussing UK pension law explained, "The law relating to pension trusts . . . involves no departure from established trust law. Rather an ever-adaptable trust law is developing on the foundation of established principle to meet the particular problems to which pension schemes give rise." Lacy S. and Topham, G. "The Powers and Duties of Pension Scheme Trustees" in Tolley's Pensions Law (1999) at E2.

14 The court more fully expressed this concept as follows: "It will not do to reject those stocks as unsafe which are in the management of directors whose well or ill directed measures may involve a total loss. Do

20. The *Amory* decision differs from the contemporary rule in its explicit insistence on the avoidance of "speculation" and emphasis on "income" and "safety." Applying these elements of the *Amory* decision, US courts retreated wholesale from the spirit of the *Amory* opinion. They moved away from its process-oriented approach, and returned to a more traditional approach in defining prudent investment management behaviour for trustees responsible for managing trust assets. This was reflected in several ways. First, specific types of investments were declared to be "speculative" *per se* and, thus, in violation of the prudent person rule. Second, the post-*Amory* courts focused on a trustee's duty to preserve capital, even at the cost of failing to protect trust assets from the ravages of inflation. Third, the courts continued to review trust investments on an investment-by-investment basis, without regard to the rest of the trust's portfolio.[15]

21. As a result, the prudent person rule as applied in the US was quite restrictive in its application to trustees, essentially until the passage of the ERISA legislation in 1974, which applied only to the trustees and other fiduciaries of pension plans sponsored by private (non-governmental) employers. Public pension plans, that is those sponsored by state and local governments for their employees, have also largely adopted a similar prudent person approach to the management of pension assets.[16] The restrictive common law standard as applied to other than pension trusts, however, prevailed in the US well into the 1980s.[17] A similarly restrictive approach remained in effect for pension trusts in the UK well into the 20th century.[18]

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what you will, the capital is at hazard. If the public funds are resorted to, what becomes of the capital when the credit of the government shall be so much impaired as it was at the close of the last war? Investments on mortgage of real estate are not always safe. Its value fluctuates more, perhaps, than the capital of insurance stock. Again, the title to real estate, after the most careful investigation, may be involved, and ultimately fail, and so the capital, which was originally supposed to be as firm as the earth itself, will be dissolved." *Harvard College v. Amory*, 26 Mass. 454 (1830).

15 For the United States experience, consider, for example, the law of New York state: In *King v. Talbot*, 40 N.Y. 76 (1869), New York courts limited permissible trust investments to government bonds and mortgages and declared investments in shares of stock imprudent. In 1889, the New York legislature limited trust investments to government bonds and mortgaged debt securities unless otherwise directed by the creator of the trust. This law remained in effect until 1950 when the list of permissible investments was expanded to permit investments up to 35% in corporate stocks and bonds.

16 Almost all state and local government pension systems in the United States, although not subject to the federal ERISA law, operate under the prudent person rule, having moved away from a quantitative limitations approach to regulation. Nonetheless, a minority of states (10 of 50 as of 1996), continue to use a combined approach to regulation by maintaining a "legal list" (i.e., quantitative limits) in addition to the prudent person standard. This approach, however, is in decline. For instance in 1987, 26 states used this combined approach; by 1996 the number had declined to 10 states. Only three states continued to use the legal list approach alone. For those states using quantitative limitations the most common quantitative restrictions were on the percentage of investments in equities (averaging 53% maximum), real estate (averaging 26% maximum) and foreign investments (averaging 8% maximum). Additionally, a small number of these plans are sometimes subject to political pressures, resulting – albeit infrequently – in some very specific investment restrictions (e.g., legislative encouragement of so-called "economically targeted investments" and restrictions on investing in tobacco stocks and so forth). Harris, J. "From Broad to Specific: The Evolution of Public Pension Investment Restrictions" Public Retirement Institute (July 1998); *see also*, Moore, C.L. "Protecting Retirees Money: Fiduciary Duties and Other Laws Applicable to State Retirement Systems, 4th edition (August 2000).

17 The hornbook restatement of the US common law, which summarises the law generally applicable to non-pension trusts, did not embrace a broad portfolio-based approach to asset management until 1990. *See* Restatement Third of Trusts (U.S.) revised in 1990 and Halbach, E. "Redefining The 'Prudent Investor Rule' For Trustees" in Trusts & Estates, December, 1990 at pp. 14-22.

18 In the United Kingdom, the pension laws limited the nature of investment under both 1925 and 1961 legislation. The 1925 legislation, for instance, limited investment to certain government or government-

22. As a result, there is a large body of commentary criticising the inability of the US common law rule to accommodate newer investment products, methods and theories (the concepts of modern portfolio theory, hedging, securities lending practices, etc.).[19] Under this traditional approach, trustees were thus discouraged from contemplating the use of newer investment strategies and products and from reviewing an investment opportunity in the context of an entire portfolio.

III. The Prudent Person Rule In Practice

23. In this section we provide some detail about the UK and US rules as applied to pensions, a brief overview of some additional countries that apply a prudent person rule or approach, and some general remarks regarding the rule's flexibility.

24. *UK Application of the Prudent Person Rule*. In the United Kingdom, the duties and powers of pension trustees derive from three sources: (1) the trust document and rules of the pension scheme; (2) the general law applicable to trustees, which is a mixture of legislation – such as the Trustees Act of 1925 – and case law; and (3) the law specific to trustees of occupational pension schemes, found largely in the Pensions Security Act 1993 and Pensions Act 1995.

25. Generally, in carrying out their powers and obligations, pension trustees in the UK are bound to exercise reasonable care and to show the prudence and diligence that an ordinary man of business would in the exercise of his own affairs. In the words of a 19th century court, the duty is to "take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound."[20] In accordance with common law principles, pension trustees also have a general duty to invest the pension scheme's assets and not allow them to sit idle, unless immediately required for the payment of benefits or other purposes.

26. In addition to these common law obligations, the powers and duties of pension trustees are further codified at Sections 33-36 of the Pensions Act 1995,[21] as follows:

1. The trustee and any person to whom the function has been delegated, has a duty of care to exercise skill in the performance of the investment function, exercising any special skills they may possess.

2. When choosing investments, the trustee must have regard for (a) the need to diversify investments insofar as appropriate for the pension scheme; (b) the suitability of the type of investment for the pension scheme and (c) the suitability of the particular investment; the trustee also must (d) obtain proper advice on their investments, and (e) act in accordance with their statement of investment principles.

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sponsored securities and to stocks of local authorities and certain railways and utilities. The 1961 legislation was somewhat more flexible; 1995 legislation essentially eliminated such *per se* limitations.

19 *See, e.g.,* Johnson, S.P. "Trustee Investment: The Prudent Person Rule or Modern Portfolio Theory, You Make the Choice", 44 Syracuse Law Review at p. 1175-1195 (1993); Gordon, J.N., "The Puzzling Persistence of the Constrained Prudent Man Rule", 62 N.Y.U. L. Rev. 52 (1987); and Longstreth, B. "Modern Investment Management Theory and the Prudent Man Rule" (1986).

20 *Re Whitely* (1886) 33 Ch D 347as cited in Moore, N. "Trustees' Duties in Relation to Money Purchase Pension Schemes" in Tolley's Trust Law International vol. 13, no. 1 (1999).

21 This summary is based on Lacey, S. and Topham, G. "The Powers and Duties of Pension Scheme Trustees" in Tolley's Pensions Law (1999) at E2.

3. The trustee must prepare and maintain a written statement of investment principles that addresses (a) the kinds of investments to be held; (b) the balance between different kinds of investment; (c) risk; (d) the expected return on investments; and (e) its policy for assuring compliance with the investment principles set forth in the statute.

4. Subject to these rules, the trustee's power to invest is broad, and includes the power "to make an investment of any kind as if they were absolutely entitled to the assets of the scheme."

5. The trustee may delegate investment functions to a fund manager legally authorised to undertake investment business in UK; the trustee, however, must assure the fund manager has appropriate knowledge and experience, and monitor the fund manager's performance.

27. The UK law also restricts employer-related investments ("self-investment"). Specifically, these investments are restricted to 5% of the pension scheme's assets. Loans to the employer are totally prohibited.

28. UK law generally takes a "whole portfolio approach." Specifically, trustees and their investment managers are judged by the standards of portfolio management theory current at the relevant time and the level of risk in the portfolio as a whole will be looked at, rather than on a per investment basis.[22]

29. *US Application of the Prudent Person Rule*. As previously noted, the US rule is set forth in the Employee Retirement Income Security Act of 1974 (ERISA). ERISA Section 404 sets forth the general standards of fiduciary conduct, requiring that plan trustees and other fiduciaries to the pension plan discharge their duties in the following manner:

1. "Solely in the interest of plan participants and beneficiaries";

2. "For the exclusive purpose of providing benefits" and "defraying reasonable expenses of administering the plan";

3. "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 with like aims";

4. "By diversifying investments . . . so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so"; and

5. In accordance with plan documents.

30. Unlike UK law, the US pension statute does not expressly require pension plan fiduciaries to establish an "investment policy." The US Department of Labor, however, has strongly encouraged their preparation and use.[23]

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22 See, e.g., *Nestle v. Westminster Bank* (1988); s*ee also,* Tolley's Pensions Law (1999) at E2 and G1.

23 See 29 US Code of Federal Regulations (C.F.R.) Section 2509.94-2(2). ERISA Section 402(b) requires pension plans to have a procedure for establishing and carrying out a "funding policy" consistent with the objectives of the plan. It is unclear whether the statute requires the funding policy to be set forth in a written document, although it is generally strongly recommended that it be so formalised. The better interpretation of this provision is that it also implicitly requires the development of a statement of investment policy, although there has been no explicit interpretation by courts or the US regulator on this point.

31. To the extent a plan fiduciary delegates investment responsibility to an investment manager, that manager is subject to the prudent person rule as expressed in Section 404.[24]

32. Although the ERISA prudent person rule essentially codifies the common law, US courts have in fact interpreted this codification of the law to be a more exacting standard. One often-quoted judicial opinion stated that the duties of an ERISA trustee are "the highest known to the law."[25]

33. Similar to the UK law, the US law also supplements the general standard by explicitly addressing the issue of self-investment. It places quantitative limits on a pension plan's acquisition and holding of employer securities and real property. It also expressly prohibits numerous specified transactions between a plan, plan fiduciaries and affiliated "parties in interest."[26]

34. ERISA takes a "whole portfolio approach" to plan asset management. The US Department of Labor specifically clarified that the statutory standard should be interpreted to mean that the "prudence of a particular investment decision should not be judged without regard to the role that the proposed investment or investment course of action plays within the overall portfolio."[27]

35. In interpreting the statute, both the US Department of Labor and the courts have stressed the importance of "process." The Department's regulatory pronouncements indicate that fiduciaries should give "appropriate consideration" to all relevant factors in assessing an investment; employ proper methods to investigate, evaluate, and structure investments; act in a manner in accordance with others who have a capacity and familiarity with such matters; and exercise independent judgement when making investment decisions.[28] The regulator has steadfastly refused to develop any list of investments or investment techniques that might be considered *per se* permissible or impermissible.[29]

36. *Countries that employ the prudent person rule*. Most countries applying a version of the prudent person rule as described above have an Anglo-Saxon common law legal tradition. These would include among others Australia, Canada, Ireland and, as discussed, the United Kingdom and the United States.

37. Certain non-Anglo-Saxon countries also use a prudent person approach, including principles such as diversification and dispersion in their regulatory framework. These would include, for example, Italy, Japan and the Netherlands, among others. More information is needed to compare and contrast the prudent person approach in these countries to those with an Anglo-Saxon basis.

38. In some cases, the prudent person rule is accompanied by certain quantitative restrictions. However, some of those restrictions – such as those that require diversification or limit self-investment – are, in effect, an expression of aspects of the prudent person rule. The information in the following

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24 ERISA Sections 402(c)(3) and 405(c).

25 *Donovan v. Bierwirth*, 716 F.2d 263 (2nd Cir. 1982), cert. denied, 459 U.S. 1069 (1982).

26 ERISA Sections 406 and 407.

27 29 US Code of Federal Regulations (C.F.R.) Section 2550.404a-1(b), first published in 1979.

28 29 US Code of Federal Regulations (C.F.R.) Section 2550.404a-1.

29 For instance, with respect to the use of derivatives, the US Department of Labor indicated that in determining the propriety of such an investment plan fiduciaries are required to engage in the same process and undertake the same type of analysis they would in making any other investment decision. This would include considering how the investment fit within the plan's investment policy, what role the particular derivative plays in the plan's portfolio, and the plan's potential exposure to losses. The regulator also cautioned, however, that plan fiduciaries are responsible for securing sufficient information to understand the investment prior to making it. US DOL Information Letter, dated March 21, 1996.

paragraphs is intended to offer some examples and is not intended to comprehensively include all OECD countries.[30]

39. For instance, in the United Kingdom and United States, there is a general *diversification requirement*.

40. Among countries without an Anglo-Saxon tradition, the Netherlands also includes a general diversification requirement. Some countries, by contrast, impose quantitative limits rather than a general diversification rule. For example, Italy permits only up to 15% of a fund to be in one investment.

41. *Explicit restriction of self-investment* is also typical in prudent person countries with an Anglo-Saxon tradition. These include Australia (5%); Canada (10%); UK (5%); and the US (generally 10%).[31] Ireland requires disclosure when the 5% threshold is crossed. Non-Anglo-Saxon countries with a prudence person approach also sometimes include similar explicit restrictions, such as the Netherlands, which imposes what is generally a 5% restriction.

42. Additionally, some prudent person countries, such as Canada, impose *ownership concentration limitations* on holdings of securities of non-affiliated firms.

43. Prudent person countries may also place *quantitative restrictions on certain classes of domestic assets*. For example, Canada limits real estate investment to 5% of the portfolio.

44. Foreign asset limitations also are not unheard of. E.g., Canada (30%).

45. The more explicit restrictions placed upon a pension trustee or fiduciary, of course, the less distinguishable the rule from the quantitative limitation approach employed by many other countries. Indeed, countries employing a combination of the two approaches present a significant challenge in comparing outcomes under the two methods of investment regulation. (See discussion below at Part VI of this paper.)

46. *Prudent Person Rule Can Vary in Application*. It is important to observe, based on the discussion above, that in practice the prudent person rule is interpreted, calibrated and applied in a variety of ways. This can be demonstrated by comparing the rule as historically applied with its contemporary form, the details of the contemporary rule in the UK with those in the US, and the rule as applied to pensions with the rule as applied in non-pension trust contexts. Historically, as identified above, the prudent person rule was oriented towards the avoidance of risk and the analysis of investment decisions reviewed by courts on an investment-by-investment basis. By contrast, contemporary interpretations of the rule increasingly emphasise process (that is, how the investment decision is made) and place individual investment decisions in the context of a fiduciary's management of the entire trust portfolio.

47. Similarly, the details of rule varies from jurisdiction to jurisdiction. For instance, the US incorporates a "prudent expert" standard in its pension laws, whereas the UK uses an "ordinary man of business" standard. Likewise, some countries will more explicitly state various aspects of the rule than others. For example, the UK explicitly requires fiduciaries to develop a statement of investment policy to guide investment decision making. In the US, however, there is no explicit rule on this point.[32]

[30] This information generally draws upon material in a prior OECD survey. DAFFE/AS/PEN/WD(2000)3/REV1.

[31] The rule in the US differs somewhat in its application to defined contribution plans.

[32] See discussion at fn. 23 above.

48. Within a country, the precise parameters of the rule may vary with the context. As noted above, this is true of the nature of fiduciary obligations generally: for example, the precise nature of fiduciary obligations running from a corporate director to a corporation and its shareholders will vary from the nature of fiduciary obligations running from trustee to a trust and its beneficiaries. This is also true within the trust context itself: the precise rules applied to pension trusts – in both the UK and US – differ from those applied to non-pension trusts. Both the UK and US have developed prudent person rules specific to pensions or added rules that complement the basic rule. Within the US, the common law rule as applied to bank trusts and other institutions has not developed in lock step with the pension rule. (This is reflected in investment practices and performance. See below at Section IV.)

49. More generally, in designing a prudent person rule applicable to pension asset management, some jurisdictions rely more on a "purer" form of the rule, albeit often supplemented with rules providing additional specificity to the general standard (e.g., UK, US); other jurisdictions appear to use a combined approach that also relies in part on quantitative restrictions (e.g., Canada, certain US public (state and local government) plans, EU directive.)

50. *Flexibility of the Prudent Person Rule*. Notwithstanding the differences, in its contemporary application in the UK and US, the prudent person rule has shown itself to be broadly applicable, flexible and resilient. This may be because in its contemporary form the prudent person rule is largely a broadly worded set of principles intended to lead to prudential decision-making, rather than to dictate outcome. The flexibility of the rule in application is its principal strength and weakness.

51. Flexibility is needed to accommodate the wide variety of objectives and circumstances that different plan fiduciaries may face and to adapt over time to changes in the operation of financial markets, in available investment products and in the practices and theories employed by asset managers. The concept of risk and risk management has changed dramatically over time. This is reflected in the practices and objectives of asset management both in and outside of the pension fund context. The rule has enabled fiduciaries the flexibility they need to make investment management decisions in this ever-changing environment. It also allows plan fiduciaries to react without exogenous constraints to changing market conditions and pension fund needs.[33]

52. Because the prudent person rule can be implemented in a flexible manner, however, it may not be as easy to determine when the rule is violated as it is to determine when a quantitative restriction is violated. This may place more demands on pension fund fiduciaries, their investment managers, pension supervisors, and the judiciary.

53. *Applicability to Member-Directed Plans*. The discussion thus far has focused on the application of the prudent person rule to the investment management of pension fund assets. The rule applies, however, much more broadly. For example, the rule continues to have a significant role to play in the management of defined contribution vehicles with member-directed accounts. Thus, under the rule in the US, plan or fund trustees are required to select and review investment options available to plan members. In carrying out such responsibilities, trustees are expected to assure the availability of an appropriate array of investment choices for members, considering the composition of the membership and their needs, the costs associated with each available investment and whether or not the investment is being adequately managed. In doing so, trustees to whom the prudent person rule applies may establish an investment

[33] A dramatic example of this flexibility in practice is the recently publicised case of the Boots Pension Scheme, one of the largest funds pension funds in the UK. The trustees of the Boots Scheme changed its investment strategy and significantly restructured its portfolio by selling all of its equities between the spring of 2000 and July 2001. The portfolio moved from a 75/25 equity/bond split to 0/100.

policy and benchmarks by which to measure and monitor the performance of each investment option, replacing them when appropriate.

54. *Constraining Effect On Behaviour.* Despite the fact that the prudent person rule is expressed in terms of a fairly broad principle, as discussed below, it has had a significantly constraining effect on investment management of pension and other trust assets.

IV. Prudent Person Rule and Investments

55. This section discusses some available empirical data regarding investment performance under the prudent person rule. It appears from the literature that trustees and fiduciaries subject to the prudent person rule invest cautiously. Presented below is a brief overview of some of these findings and the presentation of some possible explanations for this observation.

56. *Empirical Data Regarding Investment Performance Under the Rule*. Empirical data suggests that pension funds and other trusts subject to prudent person principles are invested cautiously. Indeed, commentators reviewing pension funds and other funds subject to the common law prudent person rule generally observe that the rule has had a constraining effect on investment management behaviour.

57. In reviewing the literature, however, one must carefully distinguish between the various versions of the rule being reviewed. In the US, for instance, much commentary has focused on the common law rule as applied to non-pension trusts. As noted above, the common law rule in the US, which is applied for instance to bank trust funds, was late in accommodating modern portfolio theory and more recent financial instruments now frequently used in asset management, as compared to the rule applied to US pension plans. Similarly, conclusions from these studies must be placed in some international perspective. Although the studies discussed below all suggest that pension funds, whether in the US or UK, are invested cautiously, as the Myners' Report pointed out, US pension funds are much more likely to invest in the private equity and venture capital markets than UK funds.[34]

58. Moreover, comparing fund performance or asset allocation in the aggregate may be misleading, as many of these trusts or funds will have entirely different short- and long-term needs than others. Presumably, these differing needs are reflected in the asset allocation of their portfolios. For instance, there is no reason to expect that a pension fund should have a similar portfolio to either another pension fund or a mutual fund, or that all mutual funds will have similar portfolio preferences, given the wide variety of objectives and styles of fund management. Looking at average investment behaviour, therefore, may provide very little information from which to draw significant conclusions. Notwithstanding these reservations, there appears to be some consistency in findings among studies.

59. One study, which reviewed US data, concluded that under the prudent person rule investment managers tended to tilt the composition of their portfolios over time toward stocks that courts might view as prudent.[35] Notably, this study found that bank trust managers acted more cautiously in this regard than

[34] According to the Myners' Report overseas investors – particularly from the US – provided over 70 percent of the UK private equity industry's funding. Moreover, investment by overseas pension funds in UK private equity markets tripled during the same time period (1996-2000) that the level of annual investment by UK pension funds was falling. Myners' Report at p. 19.

[35] Del Guercio, D. "The Distorting Effect of the Prudent-Man Laws on Institutional Equity Investments" in Journal of Financial Economics 40 (1996) at p. 31-62. *See also*, Gompers, P.A. and Metrick A., "Institutional Investors and Equity Prices" NBER Working Paper 6723 (1998), which suggests that "large" institutional investors – asset managers with greater than $100 million under discretionary control – prefer stocks that have greater market capitalizations because of fiduciary concerns, liquidity and transaction-cost

pension fund managers; in turn, pension fund managers were more cautious than those managing mutual fund portfolios. This finding corresponds with the fact that common law trust standards in the US are historically more constraining than the statutory ERISA standards imposed on pension fund fiduciaries.

60. Another study, which reviewed the performance of the equity portfolios of UK pension funds from 1983-1997, made a similar finding to the US study. It found a similar pattern in the returns of most funds and the FT All Share index and concluded that with respect to their equity portfolios most pension funds were "closet trackers" of the index.[36]

61. The "Myners' Report" issued earlier this year identified similar investment management practices in its review of UK pension funds and their investment management activities. Specifically, the report found that the pension trustee practice of reviewing investment manager performance by "benchmarking" provides incentives to "cling closely to stock market indices." Further, incentives were aligned such that there was little investment in new and different asset classes, such as private equity.

62. Finally, a 1985 survey of US managers of bank trust assets, college and university endowments, private foundations and corporate pension fund sponsors – although a bit dated – found that one-third of the managers agreed that the version of the prudent person rule that applied to them constrained their investment activities. Bank trust departments, subject to the most rigid version of the prudent man rule, reported the most constraint, while pension fund sponsors subject to ERISA, the more liberal version of the standard, reported the least constraint. The survey also found that many new or unconventional products and techniques were considered legally precluded or questionable by a significant number of fiduciaries. Although some "less conventional investments," such as venture capital, real estate and foreign equities, had gained acceptance in portfolios, others, such as options, futures, and index funds were not typically employed.[37]

63. *Explaining Cautious Investment Behaviour Under Prudent Person Rule*. There seem to be a number of somewhat overlapping reasons for the investment management behaviour identified in the studies noted above. These include: the substantive antecedent common law; the nature of common law lawmaking; benchmarking practices and herding behaviour; the due diligence and process-orientation of the prudent person rule; and concerns with liability.

64. *Substantive Antecedent Law*. As discussed above, the contemporary prudent person rule is historically rooted in prior versions of the rule that emphasised the preservation of capital rather than the achievement of investment gain, investment-by-investment review, and per se restrictions on certain investments. This history colours the rule and its interpretation by trustees, fiduciaries, regulatory authorities and courts. Even where the prudent person rule has a statutory basis, as in both UK and US pension law, the common law antecedents continue to play a role in the interpretation of the rule's parameters. Moreover, courts may be ill-at-ease considering and reviewing complex portfolio

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motives, and historical return patterns for different types of stocks; and Johnson, S.B. and VanDerhei, J.L., "Fiduciary Decision Making and the Nature of Private Pension Fund Investment Behavior" 55(4) Journal of Risk and Insurance at p. 692-700 (1988), hypothesising that the performance incentive of pension fund fiduciaries to maximise risk-adjusted return is curtailed by the fiduciary standard (in this case, as expressed in the U.S. law).

36 Thomas A. and Tonks I. "Equity performance of segregated pension funds in the UK", Journal of Asset Management v. 1, #4, at p. 321-343 (2001). This study is limited to a review of the equity portion of the portfolios for funds reviewed. The authors estimate that about 57 per cent of assets in funds are in UK equities; the remaining portion of the portfolio is not analysed.

37 Longstreth, B. "Modern Investment Management and the Prudent Man Rule" (1986) at p. 6.

management techniques, especially where payments to retirees are at stake, and thus, have some inclination to resort to a review of the performance of a particular asset rather than an entire portfolio.[38]

65. *Nature of Common Law*. Judicial lawmaking, particularly in common law jurisdictions, is a slow and backward-looking process. First, courts traditionally respect and adhere to legal precedent and standards established in previous cases. Second, courts must wait for appropriate cases or controversies to either promulgate new or reinforce old standards of law. Each of these elements slows the acceptance of contemporary theories, practices and products used in asset management.

66. Legislators and regulators may step into the breach where the courts do not accommodate changing practices. Even so, jurisdictions with longstanding prudent person traditions are cautious in adapting to expansive new laws or "liberalisations," and trustees and fiduciaries reticent to quickly take advantage of the changes. In the United States, for instance, it took not only the passage of federal law in 1974, but further regulatory action by the US Department of Labor to affirmatively clarify for US pension plan trustees that they could employ modern portfolio theory within the prudent person framework.

67. In the United Kingdom, the 1995 pension laws provided trustees the power to invest pension assets and select investments subject to a prudent person rule. As noted above, subject only to restrictions placed on them by the pension scheme and the fiduciary duty of prudent investment, the trustees have the same power to make an investment of any kind as if they were absolutely entitled to the assets. This law, in effect, conferred a wide range of investment power – making prior legislation conferring less authority no longer applicable.[39] Notwithstanding the legislation, according to at least one commentator, there was some debate about the sufficiency of the statutory authority. Specifically, because the 1995 legislation did not define "investment", doubt was expressed that the use of trust funds to acquire assets that are likely to produce capital return rather than an income stream was permitted under the legislation. While this was likely an overly cautious view, it is apparently common to include a number of powers in the trust document to assure that trustees can engage in some activities that may not strictly be regarded as "investments" under the statute itself. Two of the most common "activities" in this category are the power to purchase options and futures and the power to engage in securities lending.[40]

68. *Benchmarking Practices and Herding*. Numerous commentators have identified significant "herding" behaviour among trustees and fiduciaries and their designated investment managers. The Myners' Report noted that the practice of "benchmarking" investment manager performance may be a cause of this "herding." Benchmarking, of course, may be a natural result of the standard of care imposed on a trustee to act as an ordinary prudent person of business entrusted with the management of another's money. To find out what ordinary prudent persons are doing, one might look at a peer average or relevant index as a benchmark.[41] Indeed, trustees are likely to find themselves liable if the performance of

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[38] As one legal commentator observed: "[C]ontemporary economic theory dealing with investment is difficult for the lawyer to understand, and when understood is not always convincing." Haskell, P.G., "The Prudent Person Rule For Trustee Investment and Modern Portfolio Theory" in North Carolina Law Review vol. 69 at p. 87 (1990).

[39] Under the 1925 Trustee Act, trustees had a fiduciary duty to protect the trust capital and to apply the capital and its income according to the trust deed; absent special provision in the trust deed, the act limited pension fund investments to British government or government-guaranteed securities and to the stocks of local authorities and certain railways and utilities. This was superseded by legislation in 1961 that considerably widened the scope of authorised investments to include company securities and unit trusts.

[40] Marshall, J. "Pension Fund Investment and Safeguarding Fund Assets" in Tolley's Pensions Law (1999) at G1.15.

[41] Benchmarking practices are of at least two kinds. First is the use of an appropriate market index or peer average that plan fiduciaries use as a baseline against which to measure the performance of the fund's

monitored investment managers is consistently below average and there have been no steps taken by the trustees to alter the situation. As one US commentator noted, "[E]ven the liberality of ERISA's prudence standard has proved insufficient to overcome the craving for safety in numbers (and the attendant bias against innovation) that characterises fiduciaries subject to less sophisticated versions of the prudent man rule."[42]

69. *Due Diligence and Process-Orientation*. The prudent person rule emphasises process rather than investment outcome, thus placing a premium on fund governance, deliberative decision-making and appropriate documentation. In practice trustees have implemented their due diligence obligations and monitoring processes by using such practices as the benchmarking of performance, as discussed above, and by employing the expertise of a consultant community to assist them in the process of reviewing plan asset management. The deliberative and transparent nature of the process of making and reviewing asset allocation and investment decisions inherently breeds more cautious management.

70. One result of the process may be the recognition that it is very difficult to pick and assess investments and investment managers. The most obvious way in which trustees can monitor fund managers is by reviewing performance, selecting managers who have exhibited the highest returns in the past and firing fund managers who fail to perform. But comparing manager performance may be difficult when managers adopt different levels of risk and different strategies or styles, or have differing mandates from the trustees (hence the reliance on benchmarks appropriate to each various class of investment managers, as noted above). Additionally, in the short term, market volatility also makes the analysis more difficult. Indeed, it is difficult to show empirically that past years of investment manager performance sufficiently predict future performance.[43] As a result, trustees may also review and assess investment manager background and training, assess brand name of the firm, and use size of an investment management business or years of experience in the business as additional measures of investment management ability. Given the difficulties in selecting and assessing investment managers, the deliberative process itself may give rise to the conclusion that indexation (explicit or implicit) may be the most prudent route.[44]

71. Despite the empirical data – which points to clear trends in investment behaviours under the prudent person rule (i.e., the tendency to invest in larger companies, herding and the resulting explicit or implicit use of indexing) – there has been little empirical study of the pension fiduciary's decision making process, as distinguished from studies focusing on its outcomes. In this regard, the Myners' Report findings focus on the practice of benchmarking, and another study, a survey of large US pension fund

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investment managers. Second, the managers themselves may use a market index or benchmark around which to build a portfolio.

42 Longstreth, B. "Modern Investment Management and the Prudent Man Rule" at p. 36.

43 One recent study found evidence of significant persistence in the performance of fund managers over relatively short (one-year) time horizons. The study, however, did not account for the costs of investment management. Additionally, its author concluded that even assuming the statistical significance of the findings, it would be difficult for pension fund trustees to take advantage of them, because the findings suggest that investment management mandates should be set up on a yearly basis. Changing managers at such frequent intervals, however, could impose substantial transaction costs, outweighing the benefits gained. Tonks, I. "Performance Persistence of Pension Fund Managers", February 2002.

44 See, e.g., Shah, A. and Fernandes, K. "The Relevance of Index Funds for Pension Investment in Equities" World Bank Policy Research Working Paper 2494, November 2000.

managers, finds a great deal of heterogeneity in the decision making processes employed by pension fiduciaries under the prudent person rule.[45]

72. *Threat of Liability*. Where the threat of supervisory review, sanctions, litigation or liability is real and credible, courts and regulators have substantial ability to shape the manner in which a rule is interpreted and applied by fiduciaries and investment managers. At bottom, the ultimate reason the other enumerated factors impact upon behaviour is because they are associated with a credible threat of liability or sanction.

73. As one commentator observed: "A collective savings institution is constrained by legal and actuarial requirements…….While there are penalties for violating these risk thresholds, there are no obvious rewards for out-performing a minimum target return. This encourages a defensive attitude to asset management."[46] Similarly, an observer of US fiduciary activity hypothesised that the exposure of ERISA fiduciaries to increased liability altered the incentive structure by which they operate. "Specifically, the incentives to maximise risk-adjusted return was severely curtailed" because the fiduciary's level of performance was to be largely evaluated in terms of prevailing professional or other standards applicable to pension asset management.[47]

V. Identifying Possible Prerequisites for Successful Rule Implementation

74. This section tries to identify some key factors that may enable the effective implementation of the prudent person rule as applied to the investment management of pension assets. As noted above, the rule generally appears to successfully regulate this important activity, even though historically it also may have tended to constrain the implementation of new investment management techniques and tilt some pension plans into possibly sub-optimal investment strategies. Below we discuss the role of the regulator; supervisory, plan member and other monitoring; governance framework; the judicial system; and the availability of adequate remedies in the success of the prudent person rule.

75. *Regulatory Role*. Regulatory pronouncements can have a significant effect on the manner in which the prudent person rule is implemented by plan fiduciaries and trustees and thus have an effect on how much the general rule restrains certain activity – especially where rule violations will result in sanction or penalty. Thus, regulators can chill or encourage investment practices that may not clearly or comfortably fall within the scope of prudent practices. In a trust and fiduciary culture that appears to be quite cautious in application of the prudent person rule, regulators and supervisory bodies may have particularly significant leverage to shape and define behaviour under the rule.

76. One example, which was mentioned earlier, involves the US Department of Labor pronouncement regarding the role of modern portfolio theory under the prudent person rule, which clarified the appropriateness of its use to a rather skittish trustee community. Similarly, the US Department clarified the role and management of derivatives in pension fund portfolios.[48] In this manner a regulator can massage the precise contours of the rule in application.

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[45] Worzala, E. and Bajtelsmit, V.L. "How Do Pension Fund Managers *Really* Make Asset Allocation Decisions?" Benefits Quarterly, 1999.

[46] Hepp, S. "The investment behaviour of European pension funds: implications for Europe's capital markets" in "The Future of Pensions in the European Community" ed. Mortensen, Jorgen (1992).

[47] Johnson, S.B. and VanDerhei, J.L., "Fiduciary Decision Making and the Nature of Private Pension Fund Investment Behavior"55(4) Journal of Risk and Insurance at p. 692-700 (1988).

[48] *See* footnote 29.

77. *Supervisory, Plan Member and Other Monitoring*. Another key element in successful implementation of the prudent person rule is the ability of the supervisory authority and plan members to monitor plan investment management activity and to institute legal proceedings, whether judicial or administrative in nature. (The right to institute such proceedings, of course, must be balanced against the typically costly and timely nature of judicial or administrative intervention.) For effective monitoring to occur there must be adequate information available to the supervisory authority and plan members. This requires an effective reporting and disclosure regime.[49]

78. *Governance Framework*. Because the prudent person rule is a rule of process, it is very important that regulatory and supervisory authorities establish mechanisms that encourage or ensure that the governance framework of pension funds is sufficiently robust to produce appropriate decision making regarding investment management and sufficient monitoring of the portfolio management function. While a full discussion of fund governance is beyond the scope of this paper, suitability and competency requirements may be appropriate to assure that pension fund trustees and other fiduciaries are up to the task of managing the investment management process, as well as of carrying out other duties associated with pension fund administration. One key governance mechanism is the statement of investment principles or policy used to guide trustee decision-making. Appropriate governance framework may also include consideration of the role that various service providers (auditors, custodians, and others with certain oversight responsibilities) might play in the governance process. Similarly, investment management consultants and unaffiliated investment managers engaged by a pension plan or fund have an important role to play in the governance process, as pointed out in the Myners' Report.

79. *Judiciary Role*. In countries that have adopted the prudent person rule, it perhaps goes without saying given the discussion above, that in many jurisdictions, the judiciary has played and continues to play a very important role. In the absence of bright-line, quantitative rules, which it can easily apply, the judiciary will tend to rely more heavily on expert testimony as to the appropriateness of a given fund's investment management practices and the process and rationale by which various investment decisions were made. Judicial reliance on experts may reinforce the tendency of plan fiduciaries to use consultants and benchmarks in their management of plan assets to assure plan asset management corresponds to industry standards.

80. *The Nature of Remedies*. The extent of available remedies for violations of the prudent person rule and resulting losses to pension funds will have a direct impact on the amount of litigation or number of administrative actions that will be instigated by members on behalf of their pension plan or fund. There are numerous ways to calibrate remedies. Anglo-Saxon jurisdictions do not necessarily calculate remedies similarly, and, courts within each jurisdiction continue to etch out the parameters and nature of remedies.[50]

81. If an appropriate balance is struck, the threat of litigation, supervisory action, liability and/or sanctions can have a tremendous prophylactic effect on inappropriate investment management activity. The benefit of the presence of an effective liability "threat" is that it reins in aberrant, unusual, and excessively risky investment management practices. The drawback is that it encourages the excessive use of benchmarks and herding behaviour among fiduciaries, trustees and investment managers, providing a large incentive to seek comfort in numbers and look like everyone else -- even if the pension plan or fund

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[49] One example of this type of robust reporting is found in the Netherlands, which embraces its own form of the prudent person approach to pension asset management. The Dutch supervisory authority requires pension funds to deliver information to the authority regarding such matters as diversification, solvency and buffers, risks, internal controls, and asset valuation.

[50] See Ali, P. and Russell, T. "Investor Remedies against Fiduciaries in Rising and Falling Markets", 18 Company And Securities Law Journal at p. 326-350 (2000) for a discussion in the broader context of fiduciary liability in managed funds, reviewing Australian, British and U.S. law.

they manage has a substantially different profile. Further, the presence of substantial liability concerns can significantly slow the introduction of innovative investment products and techniques that might be beneficial to plan asset management.

VI. Comparison of Effectiveness of Prudent-Person and Quantitative Approaches to Regulation

82. Comparing the effectiveness of the prudent person rule and quantitative restrictions on pension fund asset investment is a difficult undertaking. Prior work tends to focus on comparing the investment return under the two rules, as well as reviewing the differences in asset allocation among funds in countries with and without quantitative restrictions.

83. Some such data was provided in DAFFE/AS/WD(2000)17/REV1. The tentative conclusion presented there was that where prudent person rules were applied, higher returns were generated. Furthermore, based on available data, quantitative asset restrictions (such as those on investment in real estate or foreign assets) appeared to constrain portfolio allocations to those asset classes for the average pension fund. As noted in DAFFE/AS/WD(2000)17/REV1, however, these findings do not account for other influences on portfolios which may complement, interact with or override the effect of portfolio regulations. In other words, the findings are suggestive, but not conclusive.

84. *Identifying Methodological Concerns*. In consideration of the potential development of additional work on this issue, we begin to identify below some of the impediments to proceeding with additional empirical work on this topic. We also recommend ways to address certain of these issues.

85. *Definitional concerns*. To proceed with further work in this vein, one must first confront a definitional issue, because some countries may embrace a combination of the two forms of regulation. For example, many countries that essentially embrace a prudent person approach, as noted above, include some quantitative restrictions. Where these rules seem to be an expression of an aspect of the prudent person rule (e.g., quantitative limits on self-investment), this may not lead to definitional concerns. But where the rules address specific investment categories, such as restrictions found in Canada on real estate and foreign investment, categorisation becomes more difficult for purposes of an empirical study. A country with both substantial quantitative regulation and a requirement that assets be invested under a prudent person standard within that quantitative framework presents similar definitional challenges.

86. At a minimum, any study might need to look to the "purer" countries to better isolate the behaviours and outcomes associated with each rule. The development of a taxonomy could be undertaken to assist in this effort. Specifically, it would be useful to develop a "taxonomy" to assist in the classification of countries – especially those that combine prudent person and quantitative approaches to the regulation of pension asset investment. The taxonomy also could address the precise contours of the prudent person approach itself as applied in various countries. It may be the case that there are some distinct versions of the prudent person approach that are best distinguished for purposes of the comparison exercise.

87. *Aggregated Data*. If data is analysed on an aggregated basis, conclusions must be drawn with care, given the limitations associated with aggregated data. Regardless of whether a pension fund is operating under a prudent person rule or quantitative limitations, the manner in which its assets are allocated should differ from fund to fund. For example, one should expect a mature pension plan with numerous retirees to which it must make current benefit payments and a declining or older workforce to have a different asset allocation than a plan confronting the opposite demographic scenario. One also would expect that each of these plans would generate different investment returns on those differing portfolios. Averaging these plans together to compare them to another set of similarly aggregated plans

will provide somewhat limited insights into how pension plans fare under prudent person or quantitative regimes. As described below, it is possible to supplement the analysis of aggregated data with a case study or sector-based analysis to mitigate this concern. Finally, it is important to note, that this concern may be somewhat offset by the "herding" behaviour of pension fund asset managers identified in the studies discussed above; these studies suggest there may be less divergence in practice than what plan demographics might dictate.

88. *Role of Valuation, Funding, Accounting and Actuarial Rules and Tax Treatment*. One needs to consider valuation, funding, accounting and actuarial rules, as well as the varying tax treatment of different asset classes, when comparing asset allocation across countries. Minimum funding rules in the United Kingdom, for instance, are said to directly influence asset allocation decisions. Similarly, in comparing the differences in equity/bond allocations in the UK and the Netherlands – neither of which has in place quantitative restrictions – one commentator concluded that "[t]he evidence is overwhelming that actuarial and accounting standards have a profound effect on the split between equities and bonds."[51] These issues point to the importance of additional work on matters such as the funding standards being employed in various countries, which is proposed at DAFFE/AS/PEN/WD(2001)17.

89. *Defining Asset Allocation Constraint*. For quantitative rules, one needs to come up with a definition of when a plan is deemed "constrained" by a quantitative limit. Presumably, one would generally never observe a plan exceeding a given quantitative limitation, but one might see certain plans with allocation percentages just below an established limit. One would need to set a "collar" or range close to the limit and assume that allocations within the established range were constrained by the limitation. One might be able to identify an agreed upon convention for this exercise. The task might be more difficult, however, if one were to try to assess to what extent a prudent person rule constrains allocation. The information presented above suggests that the prudent person rule does tend to constrain fiduciaries and trustees; identifying to what extent, however, is difficult to assess. To better define the constraints operative under the prudent person rule, one could conduct a qualitative survey of investment managers subject to the rule, as further described below.

90. *Role of Domestic Investment*. It is also necessary to take into account economic conditions in each country that may drive changes in portfolio composition. Presumably, plans and funds have significant domestic investment allocations (regardless of whether or not foreign asset allocation limitations are in place.) The extent of those investments may be unrelated to either the prudent person rule or quantitative limitations – and may drive investment returns. In comparing returns in pension funds in one country to returns of those in another, one must somehow make adjustments for this factor – especially for time periods during which the markets performed quite differently from country to country.

91. *Transaction and Other Costs and Fees.* Similarly, one might need to consider the fact that trading and other transaction costs will differ from country to country, thus effecting how a pension fund portfolio is managed. Custodial and other fees will differ. Are returns reviewed net of these fees? Even if so, how do these cost structures effect asset allocation, portfolio turnover rates, and so forth? Portfolios, for instance, may be more inflexible to market conditions in the presence of higher trading costs. Could

[51] Griffin, M.W. "A Global Perspective on Pension Fund Asset Allocation" in Financial Analysts Journal (March/April 1998). *See also* Gollier, J. "Private Pension Systems" in Private Pension Systems and Policy Issues, OECD Private Pension Series No. 1 (2000) (observing that the divergence in portfolio allocation among pension funds in Germany, Netherlands, Japan, US and UK may be attributable to differences in methods of valuing equities and bonds, especially where it is possible to value bonds at book rather than market value) and Hepp, S. "The investment behaviour of European pension funds: implications for Europe's capital markets" in "The Future of Pensions in the European Community" ed. Mortensen, J. (1992).

trading and other such costs effect investment management behaviour as much or more than the difference between the rules we are comparing?

92. *Role of Corporate Governance*. Corporate governance infrastructure also likely plays a role in investment performance. While the process-oriented nature of the prudent person rule puts a priority on good governance, pension plans operating in a quantitative environment also rely on the plan's governing body to make investment decisions for the plan. If there is an effect of governance on returns, it must be identified and taken into account as one compares pension plans under prudent person rules and those under quantitative regimes. By way of example, one study of public (state, local and municipal government) pension funds in the US found that the presence of retirees on the governing board of a fund appeared to reduce returns.[52] Similarly, the Myners' Report, which has been previously referred to, places great emphasis on the role of governance in the asset allocation process.

93. *Plan Design*. Plan design also will effect asset allocation. For instance, in the presence of a minimum return guaranty provided by a pension plan to members, presumably different asset allocation decisions will be made regardless of the presence of prudent person rules or quantitative limitations.[53] Along these lines, one might need to differentiate between the performance of assets in a defined benefit plan and defined contribution plan (even in the absence of member-directed accounts).

94. *Addressing Identified Methodological Concerns*. There are a number of ways to address the concerns identified. We note some possibilities here, which are further developed in Section VII below, discussing "future work":

95. First, as noted above, a *taxonomy* could be developed to obtain definitional clarity regarding prudent person and quantitative approaches to regulation.

96. Second, concerns regarding the limitations of using of aggregated data could be addressed by supplementing that data with a *"case study"* that would review the investment management practices and investment returns of *specifically selected* pension plans of various countries that are of similar size and demographic circumstance. Alternatively, this exercise could take the form of a *"sector-based analysis"* where one would expect all pension plans across countries to be of generally similar demographic characteristics and maturity (e.g., steel or coal industry plans, plans of newer technology companies, etc.).

97. Third, to better define the roles that each of the identified factors plays in trustee investment management practices, one might want to consider *a "qualitative survey of pension trustees, fiduciaries and asset managers"* in various countries. Such a survey would inquire of these individuals directly which factors most influence their asset management decisions. A similar study was conducted in the United States in the mid-1980s. (See paragraph 62). While this would be a substantial undertaking, it could augment conclusions drawn from aggregated data.

98. The issues noted here give rise to many questions about measuring and comparing the impact of prudent person rules and quantitative limitations on pension plan asset management. These must be adequately taken into account in conducting a comparative study. Some of the activities suggested above (taxonomy; review of funding rules; supplemental case study and sector based analysis; qualitative industry survey) may ameliorate some of the difficulties noted.

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52 Mitchell O.S. and Hsin, P.L. "Public Pension Governance and Performance" NBER Working Paper #4632 (1994).

53 *See* Jensen, B.A. and Sorenson, C. "Paying for Minimum Interest Rate Guarantees: Who Should Compensate Who?" in European Financial Management, Vol. 7, No. 2, 2001 at p. 183-211.

VII. Future Work

99. This paper has provided a general description of the prudent person rule as defined in Anglo-Saxon countries, additional specific information about the United Kingdom and United States, discussed some available data on investment outcome and behaviour under the rule, identified certain elements associated with its successful implementation, and reviewed the methodological difficulties associated with seeking to compare its efficacy with that of a quantitative approach to investment regulation.

100. This initial work has demonstrated that the prudent person rule, at least as applied within the United Kingdom and the United States, is a complex, substantive rule of law that sets forth affirmative principles that influence investment behaviour and outcomes. The rule, originating in the Anglo-Saxon trust and common law tradition, can differ in its precise contours and application, leading to somewhat different outcomes. Governments (legislature, regulators and supervisors) can play a substantial role in shaping the precise contours of the rule.

101. In light of this initial work and its findings, it would be worthwhile to pursue further study of the prudent person rule and its development and application in both Anglo-Saxon-based jurisdictions and countries without such a common law or trust tradition. The analysis can be refined and further developed as described below.

1. *Expansion of research to additional countries and development of taxonomy.* Additional comparative work on the legal (statutory, regulatory and judicial) standards employed in the various countries employing the prudent person rule or a similar prudent person approach, including both countries with and without an Anglo-Saxon common law tradition, can be undertaken. Such bottom-up work would review and contrast variations in the rule's definition, including in countries employing the prudent person approach in combination with some quantitative regulation. This would ideally enable the development of a taxonomy to assist in the comparative analysis of investment performance under the prudent person rule and quantitative regulation.

   This work would require a survey of member countries and the acquisition and review of relevant legal materials (statutes, leading judicial decisions, etc.).

2. *Supplemental work related to comparison of prudent person to quantitative regulation.* A comparison on an aggregated basis of investment returns in pension plans of countries with prudent person and quantitative rules could be augmented by (1) a supplemental case study of specifically selected pension plans of various countries that are of similar size and demographic circumstance, and (2) a study of a more comparable subset of the data, such as of data from a selected economic sector or industry in which one could expect pension plans to be of similar maturity and demographic circumstance. (Additionally, this work could be augmented by a qualitative survey of trustees, fiduciaries and asset managers, further described at item 3 below.)

3. *Governance standards for investment management.* Pension fund governance has an important role to play in the effective management of plan assets, regardless of whether the plan is subject to prudent person or quantitative investment restrictions. It may have particular importance to the successful implementation of the process-oriented prudent person rule. Building on the OECD's recent work (Revised Guidelines For Pension Fund Governance; Selected Principles For the Regulation of Investments by Insurance Companies and Pension Funds), best practices or guidelines for governance focused on investment management activities could be developed. To assist in developing standards, a "qualitative

survey of trustees, fiduciaries and asset managers" could be undertaken to better understand the governance standards, structures and processes that are currently in use. Additionally, this study could elicit information regarding the extent to which the prudent person rule constrains investment management behaviour.

4. *Additional comparative work on the availability of legal relief for plan or fund members and the extent of fiduciary exposure to liability*. The nature and extent of fiduciary/trustee liability for the (mis)management of plan assets, the ability of plan members to initiate a claim (whether in a judicial or administrative forum), and the nature and extent of remedies available play an important role in the monitoring of plan asset management. Insufficient comprehensive work appears to be done in this area. In a volatile world-wide market environment, there may be an increase in litigation and increased need to attend to the effectiveness of these mechanisms, the costs they impose and the incentives and disincentives that they create. This work would review and contrast current legal standards.

   This work would require a survey of member countries and the acquisition and review of relevant legal materials (statutes, leading judicial decisions, etc.).