

Funding Climate Change: how pension fund fiduciary duty masks trustee inertia and short-termism

Claire Woods*

Abstract: This paper sets out to demonstrate the potential of pension funds to drive corporate responses to climate change. It examines first why fiduciary duty is perceived as a barrier to change in investment practices, arguing that *in theory* fiduciary duty should not be perceived as a legal barrier to inclusion of climate change in investment strategies: fiduciary duty has evolved with social expectations in the past (and should be able to adapt to the increasing importance, financial and otherwise, of climate change now). However, *in practice*, courts, commentators and trustees have interpreted prudent investment as conventional investment. Thus prudence becomes the maintenance of the status quo. Legislative clarification is needed if pension funds are to change their approach toward climate change. Second, this paper argues that the focus on fiduciary duty as a barrier masks the role of trustee behavioural biases toward inertia and short-termism. When combined with the uncertainty surrounding fiduciary duty, these result in a collective action problem: pension funds are unlikely to break with convention absent industry-wide change. Under these conditions, any institutional acceptance of innovation toward a longer term, more sustainable investment strategy that accounts for climate change will take strong leadership from pension funds themselves.

Table of Contents

I. Introduction.....	2
II. The Potential for Pension Funds to Reduce Climate Change.....	4
A. Growing Power, Growing Responsibility?.....	5
B. Climate Change: a financial risk and opportunity.....	6
III. Fiduciary Duty as a Perceived Barrier to Change.....	8
A. Fiduciary Duty in the Context of Pension Funds.....	10
1. Duty of Loyalty: Primacy of beneficiary interests.....	10
2. Duty of Prudence: the modern prudent investor.....	12
B. Pension Fund Fiduciary Duty and Non-Financial Considerations.....	14
1. US Case Law and Recent Commentary.....	15
2. UK Case Law and Recent Commentary.....	17
C. Fiduciary Duty’s Paradox: Incrementally flexible.....	19
1. Adapting to Changing Social Expectations (both Financial and Non-Financial).....	20
2. Inherent Inertia: Prudence tends toward the status quo.....	23
3. The Outcome for Climate Change	25
IV. Ingrained Inertia, Short-termism and Collective Inaction.....	26
V. Conclusion.....	29

* I would like to thank Gordon Clark, Robin Ellison, John Evans, Dorothee Franzen, Taylor Gray, Jim Hawley and Benjamin Richardson for their helpful comments on an earlier draft of this paper. Any mistakes are of course my own. This work was completed with the support of the University of Oxford Clarendon Fund Scholarship.

I. Introduction

Pension funds control, on average, assets equivalent to 76 percent of the GDP of their respective countries throughout the Western world.¹ In 2006, US pension funds held shares representing approximately one quarter of US of equity markets²; UK pension funds held shares representing approximately 13 percent of UK equity markets³. As large shareholders, their potential to influence companies in almost all industries is profound. This paper focuses on Anglo-American pension funds, because they are similar enough to make comparison straight-forward.⁴ The advent of two global crises, the global financial crisis and climate change, demands an examination of the investment decisions of pension funds. Are these financial behemoths fulfilling their potential to invest in a better future? Or are they acting myopically, concentrating on quarterly financial performance while funding business in ways that have contributed to and continue to fuel these crises?

At the time of writing, climate change and the global financial crisis present significant challenges to governments around the world.⁵ These crises are, to an extent, linked by their genesis in short-termism: in both cases, governments and industry have fostered short-term financial gain without sufficient regard to longer term social costs of the externalities at play.⁶ The Stern Review highlights the central importance of environmental sustainability to continued economic growth:

The evidence shows that ignoring climate change will eventually damage economic growth. Our actions over the coming few decades could create risks of major disruption to economic and social activity, later in this century and in the next, on a scale similar to those associated with the great wars and the economic depression of the first half of the 20th century. And it will be difficult or impossible to reverse these changes. Tackling climate change is the pro-growth strategy for the longer term, and it can be done in a way that does not cap the aspirations for growth of rich or poor countries. The earlier effective action is taken, the less costly it will be.⁷

As for the financial crisis, pension funds have been hit hard. The total assets of all pension funds in the OECD declined by \$US 3.3 trillion (that is, nearly 20 percent) from December 2007 to October 2008.⁸ If private pension assets are included that figure rises to \$US 5 trillion.⁹

From a broad ethical point of view, it is arguable that pension funds should have a wider ambit of responsibility for promoting a sustainable future, given their financial power and their incursion into service provision once the purview of the state.¹⁰ It is not argued here that fiduciaries' personal

¹ Org. for Econ. Cooperation and Dev. [hereinafter OECD], *Special Feature: Private Pensions and The 2008 Turmoil in Financial Markets*, 5 PENSION MARKETS IN FOCUS, 3, 12 (2008); see also KEITH JOHNSON & FRANK JAN DE GRAAF, NETWORK FOR SUSTAINABLE FINANCIAL MARKETS, CONSULTATION PAPER NO. 2: MODERNIZING PENSION FUND LEGAL STANDARDS FOR THE 21ST CENTURY 3-4 (2009).

² See Conference Board, Press Release, *US Institutional Investors Boost Ownership of US Corporations to New Highs* 1 (Sept. 2, 2008): 'public pension funds have increased their share of equity markets from 2.9 percent in 1980 to 10 percent 2006. ... [p]rivate pensions funds' share declined from 15.1 percent in 1980 to 13.6 percent in 2006.'

³ UK Office of National Statistics, *Share Ownership*, available at <http://www.statistics.gov.uk/cci/nugget.asp?id=107>.

⁴ See generally GORDON L. CLARK, PENSION FUND CAPITALISM (2000). English and American pension funds have many similarities in terms of governance, funding and regulation.

⁵ See e.g., WORLD ECON. FORUM, WORLD ECONOMIC FORUM ANNUAL MEETING: THE POWER OF COLLABORATIVE INNOVATION 2008, 3-17 (2008).

⁶ Cf. Nicholas Stern & Joseph Stiglitz, Opinion, *Obama's Chance to Lead the Green Recovery*, FIN. TIMES, March 2, 2009 (arguing that the financial crisis and climate change may have common solutions), available at <http://www.ft.com/cms/s/0/7c51644a-075b-11de-9294-000077b07658.html>.

⁷ NICHOLAS STERN, STERN REVIEW: THE ECONOMICS OF CLIMATE CHANGE – LONG EXECUTIVE SUMMARY ii (2006).

⁸ OECD, *supra* note 1, at 3.

⁹ *Id.*

¹⁰ See CLARK, *supra* note 4 at 16-42 (on pension funds and the retreat of the state); see Benjamin Richardson, *Putting Ethics into Environmental Law: Fiduciary Duties for Ethical Investment*, 46 OSGOODE HALL L.J. 243, 247-48 (2008)

ethical considerations should form a basis for individual investment decisions: the ethical viewpoints of individual trustees and asset managers are too subjective and idiosyncratic to form a proper basis for *ad hoc* investment decision-making. On a wider scale, however, ethics can contribute to our ontological understanding of the role of pension funds. Benjamin Richardson argues that, given their financial significance, institutional investors have an obligation to use their power sustainably by investing in firms whose activities are sustainable.¹¹ As Stern and others have argued, without environmental sustainability, the financial system ultimately cannot survive.¹²

The primary mandate of pension funds is the creation of financial returns for beneficiaries, but the extent to which this goal is achieved sustainably is a matter for trustees to decide. Pension funds have thus far shown some interest in advocating a change from the short-term focus of the financial system that has fuelled the global financial crisis.¹³ However, the recent indication of interest is a far cry from action. The financial crisis has revealed that many pension funds are struggling to fulfil their primary mandate of successful financial management on behalf of beneficiaries, let alone to introduce the new variable of sustainability into their management approach.¹⁴ However, by moving toward a longer-term investment paradigm and considering climate change when designing their investment strategies, pension funds have the potential to fulfil their mandate to beneficiaries in a more sustainable manner.

Reflecting on the context of climate change and the global financial crisis, this paper sets out to demonstrate the theoretical potential of pension funds to drive the reduction of firms' climate change impact, and to expose the practical barriers that stand in their way. It examines first why fiduciary duty is perceived as a barrier to change in investment practices, outlining recent legal developments in the area. It argues that requirements of fiduciary duty have been interpreted too narrowly, and *in theory* should not be perceived as a legal barrier to pension funds' consideration of climate change: fiduciary duty has been flexible enough to evolve with social expectations in the past (and should be able to adapt to the increasing importance of climate change now). However, *in practice*, courts, commentators and trustees themselves have had the tendency to interpret fiduciary duty's requirement of prudence as *what the majority of investors do*. The prudent course of action in this light becomes to maintain the status quo, limiting the potential for innovation in investment strategy toward the inclusion of environmental considerations such as climate change. The uncertainty surrounding the content of fiduciary duty places a practical barrier on investment innovation in this area. Legislative clarification is needed if pension funds are to change their approach toward climate change. Moreover, the focus on fiduciary duty as a barrier to investment innovation in this area masks the behavioural biases toward inertia and short-termism in trustees which are more insidious and at least as important. These biases, combined with the uncertainty surrounding fiduciary duty, result in a collective action problem: pension funds are unlikely to break with convention unless a significant number of them change their approach simultaneously. Under these conditions, any institutional acceptance of innovation toward a longer term, more sustainable investment strategy that accounts for climate change will take strong leadership from pension funds

(on the ethical obligations of institutional investors).

¹¹ See Richardson, *supra* note 10.

¹² See Stern, *supra* note 7. See also Kenneth Arrow *et al.*, *Economic Growth, Carrying Capacity, and the Environment*, 15 *ECOLOGICAL ECONOMICS* 91, 92-3 (1995).

¹³ For example, the Marathon Club, a group of institutional investors who promote long-term investment, has released a report highlighting lessons for institutional investors from the credit crunch. See generally MARATHON CLUB, *BEHAVIOURAL ASPECTS OF INVESTMENT MANAGEMENT: LESSONS FROM THE CREDIT CRUNCH* (2008).

¹⁴ See, e.g., *The Effects of Recent Turmoil in Fin. Markets on Ret. Sec.: Hearing before the H. Comm. on Educ. and Labor*, October 7, 2008 (statement of Peter R. Orszag, Director, Cong. Budget Office), available at: http://www.cbo.gov/ftpdocs/98xx/doc9864/10-07-RetirementSecurity_Testimony.pdf.

themselves.

This paper touches upon a range of important issues whose detailed examination is beyond its scope. In particular, it is not the work of this paper to undertake an empirical analysis of the financial impact of consideration of climate change. This is occurring elsewhere, and comes in addition to the many studies on the financial performance of socially responsible investment (SRI) funds conducted in the past.¹⁵ Furthermore, it does not look in detail at the role of asset managers in managing pension fund investments; instead it explores the work of trustees in the earlier stage of creating investment strategies and in monitoring delegated functions. Finally, nor does this paper look in detail at the ethical arguments for and against pension funds' consideration of climate change.¹⁶ Instead, the focus here remains upon, first, the extent to which, in theory, fiduciary duty presents a barrier to the potential for pension funds to contribute to a more sustainable financial system and in particular to have regard to the climate change as a financial risk or opportunity, and, second, on the behavioural barriers that exist in practice.

II. The Potential for Pension Funds to Reduce Climate Change

Since the early 1980s, the financial power of pension funds has become ubiquitous across the western world.¹⁷ In 2007, pension funds in the United Kingdom, the United States, Australia and Canada controlled assets equivalent to 86, 74, 105 and 55 percent of GDP respectively.¹⁸ The increase in financial importance of pension funds has coincided with a retreat of the state as the primary provider of public infrastructure and governance at the end of the Twentieth Century¹⁹. Gordon Clark argues that the influence of pension funds has expanded to enter the governance gap created as the state has retired from its zenith of service provision in the 1930s.²⁰ As the state has reduced its role in providing both physical and legal infrastructure, a space has grown for corporate and financial self-regulation. Pension funds increasingly provide the essential service of an income stream for retirees – a service that in the recent past was the purview of the state, and in the more distant past the duty of the family. Beneficiaries of pension funds therefore place a great deal of trust in the funds to create and maintain adequate wealth for their post-work years. It is little wonder that pension funds and beneficiaries are wary of any incursion into this function. Nevertheless, as the financial strength of pension funds grows, it is worth considering whether the primary wealth creation mandate of pension funds can fit within a broader agenda of fostering sustainable investment. In outsourcing part of their service provision, governments appear to have lost sight of the whole: a pension system that produces financial benefits for society with the one hand and

¹⁵ On the financial impact of climate change, see, e.g., SONIA LABATT & RODNEY R. WHITE, *CARBON FINANCE: THE FINANCIAL IMPLICATIONS OF CLIMATE CHANGE* (2007); cf. Rob Bauer *et al.*, *Socially Responsible Investing: the Eco-Efficiency Premium Puzzle*, 61 *FIN. ANALYSTS J.* 51 (2005). For meta-analyses of SRI and financial performance see e.g., Marc Orlitzky, Frank L. Schmidt & Sara L. Rynes, *Corporate Social and Financial Performance: a meta-analysis* 24 *ORG. STUDIES* 403 (2003); see also BENJAMIN RICHARDSON, *SOCIALLY RESPONSIBLE INVESTMENT LAW* 173-76 (2008) (for a brief review of various studies conducted). Despite the volume of analysis on performance of SRI funds compared to the market as a whole, there is no consensus about the financial outcome of SRI. This lack of consensus is due partly to variations in research methodology, as well as the varying meanings given to SRI funds. Further confusion is added by scholars offering different ways to *measure* performance: if part of the purpose of SRI funds is to create positive social externalities, then financial performance becomes one of several performance measures, rather than the only one: see Abigail McWilliams & Donald Siegel, *Event Studies in Management Research: Theoretical and Empirical Issues* (1999) *ACAD. MGMT. J.*

¹⁶ For a brief analysis of ethical arguments for sustainable investment, see Richardson, *supra* note 10 at 259-66.

¹⁷ See CLARK, *supra* note 4 at 17.

¹⁸ See OECD, *supra* note 1 at 12.

¹⁹ See CLARK, *supra* note 4 at 16-42; James Hawley & Andrew Williams, *Shifting ground: emerging global corporate-governance standards and the rise of fiduciary capitalism*, 37 *ENV'T & PLAN. A* 1995, 1998 (2005).

²⁰ See CLARK, *supra* note 4 at 16-42.

erodes its ecological foundations with the other cannot be a permanent solution. A rethinking of the purpose and function of pension fund investment is required in order to correct these issues.

Before proceeding further, it is worth noting that pension funds do not form a homogenous group. There are a variety of attributes that may alter a pension fund's ability to affect climate change outcomes. First, larger pension funds are undoubtedly in a stronger position to effect industry change. Larger funds have not only a larger degree of corporate control and more resources, but also stronger standards of internal competence and investor sophistication. Second, in defined benefit funds, trustees have more control over how funds are invested, whereas in defined contribution schemes, beneficiaries have a degree of autonomy to direct their own fund investment. The extent to which beneficiaries avail themselves of this ability is, however, limited, with most beneficiaries failing to opt out of default funds (this is discussed in greater detail in section IV below). Third, traditionally, higher equity holdings allow funds a greater opportunity for dialogue with firms. While it appears that pensions fund' proportion of bond holdings is currently increasing in relation to equity holdings,²¹ industry sources suggest that many of the new bond assets are corporate bonds, making any such shift's effect on pension fund behaviour less consequential (depending, of course of the nature and class of bond). Finally, whether a fund is public or private is of little relevance here, as in the US and UK private and pension funds are governed by nearly identical legal regimes (at least with respect to fiduciary duty). These differences should be borne in mind while reading the arguments that follow. While different types of pension funds will have varying abilities to effect change, this author is of the view that there enough pension funds with the attributes necessary to make a profound difference in this area.

A. Growing Power, Growing Responsibility?

The financial power of pension funds has grown steadily over the last fifty years. Given their increasing power to affect social welfare both positively and negatively, does it follow that pension funds have developed a conjunct responsibility? The natural environment is, after all, the underlying resource base of the economy.²² Drawing upon the notion that pension funds have assumed governance²³ responsibilities by virtue of their financial clout, Richardson argues that 'where financial institutions manage the assets of millions of people and have the capacity to exert huge economic influence, they must be governed by environmental standards that protect natural systems for the long term. They should be regarded as institutions with special public responsibilities based on ecological ethics.'²⁴ Richardson's argument here is ethical. He notes, correctly, that such ethical obligations are generally unenforceable under existing legal structures.²⁵ Whilst there is room to argue that pension funds are developing an ethical responsibility to use their burgeoning investment powers in an environmentally sustainable manner, legislative changes would be necessary to make any such ethical responsibility legally enforceable. While the concept is not explored in detail here, it is worth noting that such change is not without precedent: company responsibilities under corporate law have widened in recent years to include some duties to a wider stakeholder group than merely shareholders.²⁶ In the UK, for example, the *Companies Act 2006*

²¹ See, e.g., David Litterick, *Market Falls Add £40bn to UK Pensions Deficit*, Daily Telegraph (March 25, 2008).

²² See STERN, *supra* note 7; ARROW *et al.*, *supra* note 12.

²³ The term governance is here used in the broad sense, as described by JAN KOOIMAN in *GOVERNING AS GOVERNANCE* 4-8 (2003).

²⁴ See Richardson, *supra* note 10 at 247.

²⁵ See *id.* (arguing that neither appeals to conscience nor market forces alone will be sufficient to bring about a more ethical approach to investment; instead, certain regulatory reforms are required).

²⁶ See Claire Woods & Roger Urwin, *Models for Sustainable Investing: Principles for institutional investors*, 5-6 (forthcoming, 2009) (arguing for a concept of institutional investor social responsibility to run parallel to the notion of corporate responsibility).

requires directors to have regard to ‘the impact of the company’s operations on the community and the environment’²⁷ and ‘the likely consequences of any decision in the long term’²⁸ when promoting the success of the company.

In *The Rise of Fiduciary Capitalism*, James Hawley and Andrew Williams argue that pension funds are well-positioned to encourage companies to produce economy-wide social benefits alongside financial benefits.²⁹ They argue that as pension funds become universal owners (that is, as they invest across all sectors of the economy), they can derive benefit from social improvements across the economy.³⁰ Furthermore, they become more vulnerable to systematic financial risks (risks to which the entire economy is exposed). Universal owners have two broad sets of reasons for promoting social welfare as well as focussing on the growth of assets through investment: first, social improvements in any and all sectors of the economy will be beneficial to the wide range of firms in which they invest.³¹ Second, pension funds that are universal owners should have regard to the impact of their investment on factors other than financial value of assets, because negative externalities created by one of their investments in one industry will have an impact on the assets they hold in other industries.³²

These arguments raise important questions for social policy: should pension funds assume governance roles? Do pension funds owe a duty to stakeholders outside the beneficiary group? In short, is there a wider social role for pension funds? To treat these questions with the completeness they require is beyond the scope of this paper. The position that this paper takes is that pension funds generally, with the exception of some large and highly professionally run public pension funds, such as CalPERS, are not ready to assume a broad governance role. Clark *et al.*’s 2007 study comparing trustee competence with that of Oxford undergraduates showed that although education on financial matters appears to improve trustee competence³³, on average trustees were less adept than undergraduates at integrating extra-financial factors in their investment decision-making process.³⁴ Furthermore, a wider agenda of sustainability may be ethically wanting, but, as Richardson notes, no such agenda is currently enforceable against pension funds. Any agenda introduced through legislation would have to be careful not to distract trustees from their primary mandate: the creation of retirement benefits for beneficiaries. Broader governance role aside, however, this paper takes the position that the fulfilment of this primary mandate and the promotion of a more sustainable approach to investment are not necessarily mutually exclusive. Indeed, the fulfilment of the primary mandate is likely to suffer if trustees ignore the long-term consequences of financing environmental degradation.

B. Climate Change: a financial risk and opportunity

With the increasing financial prominence of pension funds in western countries comes an increasing potential to encourage the reduction in greenhouse gas emissions across economies. Pension funds could promote greenhouse gas emissions reductions in two ways while carrying out their investment mandates. First, they could consider carbon footprint as a *risk* that will increase as regulators and markets react to the increasing economic, social and environmental impact of climate

²⁷ Companies Act (2006) (UK) s. 172(d).

²⁸ *Id.* s. 172(a).

²⁹ See JAMES P. HAWLEY & ANDREW T. WILLIAMS, *THE RISE OF FIDUCIARY CAPITALISM* xv (2000).

³⁰ *See id.*

³¹ *See id.* at xv-xxvii, 3-7.

³² *See id.* at 3-7.

³³ Gordon L. Clark, Emiko Caerlewy-Smith & John C. Marshall, *The Consistency of UK Pension Fund Trustee Decision-Making*, 6 J. PENSION ECON. & FIN. 67, 75 (2007).

³⁴ *See id.* at 82.

change. Pension funds would then respond to this risk by introducing carbon footprint as an additional metric for assessing each of the assets in their portfolio, and adjusting their investment decisions accordingly. Moreover, pension funds could engage actively with the firms in which they invest on the issue of greenhouse gas emissions. A second approach would be to make specialised investments in firms that are likely to have a particularly positive climate change impact (for instance, renewable energy firms), taking a venture capital approach. This more targeted approach would treat climate change as an *opportunity* to pre-empt market forces as the demand for greener energy increases. The value of the opportunity may be augmented by government subsidies³⁵ and early mover advantage³⁶.

More importantly, pension funds' explicit consideration of climate change could have a broad, lasting influence on the priorities of businesses across economies. If pension funds were to act on climate change, by treating it as a risk, opportunity or both, they would send a strong signal to businesses about the value that they, as significant shareholders, place on climate change risk and opportunity. The business response to pension fund treatment of climate change could lead to increased attention to climate change risks and opportunities at an individual business level. In carrying out their investment mandates with a conscious regard to the context of climate change, pension funds would make an informal, but potentially highly significant, contribution to climate governance. In short, pension fund investment could help to advance a more carbon-conscious business paradigm.

Why is it, then, that pension funds do not appear to have a strong interest in moving toward a systematic assessment of the risks and opportunities of climate change? While some investment consultancies have argued that carbon footprint must be treated as a risk under the circumstances of climate change³⁷, very few pension funds have shown signs of treating the issue in a proactive manner at the investment strategy level³⁸. For most funds, climate change goes unremarked, integrated on a haphazard basis into company valuations according to the inconsistent reporting techniques of businesses. Though the risk of global warming has been widely acknowledged since the 1980s³⁹, it was until recently⁴⁰ largely restricted to the domain of the scientific community. This may explain not only why many pension funds give little or no regard to climate change into their investment strategies, but also why little has been written about how pension funds view their own

³⁵ The U.S. Department of Energy has a projected budget of \$33.9 billion for 2009 and \$26.3 billion for 2010, in addition to an allocation of \$38.7 billion under the Recovery Act dedicated to clean energy projects: see WHITE HOUSE OFFICE OF MANAGEMENT AND BUDGET, BUDGET OVERVIEW: A NEW ERA OF RESPONSIBILITY: RENEWING AMERICA'S PROMISE 64 (2009). Similarly, the UK has committed around £60 billion to renewable energy and the low carbon sector from 2009-2011: see HM TREASURY, BUDGET 2009: BUILDING BRITAIN'S FUTURE 133-35 (2009).

³⁶ See WATSON WYATT, MACRO FACTORS: THE UPDATE 6 (2005).

³⁷ See generally, MERCER INVESTMENT CONSULTING FOR THE CARBON TRUST & THE INSTITUTIONAL INVESTOR GROUP ON CLIMATE CHANGE, A CLIMATE FOR CHANGE: A TRUSTEE'S GUIDE TO UNDERSTANDING AND ADDRESSING CLIMATE RISK (2005).

³⁸ See Benjamin Richardson, *Climate Finance and its Governance: Moving to a low carbon economy through socially responsible financing?*, 58 INT. & COMP. L. Q. 597, 600 ('Although the financial sector is publishing numerous studies that warn of the impact of global warming on its self-interest, so far tangible changes in investment practices are hard to discern' [citations omitted]), at 617 (citing instances where investors *have* responded to climate change risk). Cf also IIGCC, INVESTOR STATEMENT ON CLIMATE CHANGE REPORT 2008, 8 (2008): the Institutional Investor Group on Climate Change [hereinafter IIGCC] has 22 signatories (representing around £2 trillion in assets) to its statement committing to a proactive response to climate change. The Norwegian Government Pension Fund-Global, though strictly speaking a sovereign wealth fund, has an ethical mandate: see Gordon Clark & Ashby Monk, *Resource wealth and the ethics of global investment: the legitimacy and governance of Norway's sovereign wealth fund*, Working Paper, University of Oxford (forthcoming, 2009) at 3-4.

³⁹ The Intergovernmental Panel on Climate Change was established in 1988: see LABATT & WHITE, *supra* note 15, at 5.

⁴⁰ The STERN REVIEW (see *supra* note 7) shed a new, interdisciplinary light on the problem of climate change by assessing its economic effects.

capacity to make a difference with respect to climate change.⁴¹ Still, an analogy can be drawn between pension funds' consideration of climate change and their consideration of other traditionally 'non-financial factors', including environmental factors, which is reasonably well-researched.⁴² The reason frequently put forward by pension fund trustees, asset managers, investment advisors and commentators for the reticence of pension funds toward the consideration of 'non-financial factors' is the purported legal barrier created by fiduciary duty.⁴³

This paper proceeds on the basis that given past legal decisions, legislation and commentary with respect to fiduciary duty and non-financial considerations, fiduciary duty is likely to be perceived as posing the foremost legal impediment to fiduciaries' consideration of climate change. The following section explores why fiduciary duty is often perceived as a barrier to fiduciaries' consideration of so-called 'non-financial' factors in investment decisions. It argues that the impediment fiduciary duty presents to consideration of non-financial factors has been overstated in the past: in reality, fiduciary duty presents little theoretical barrier to fiduciaries' consideration of climate change, to the extent that it poses an investment risk or opportunity.

III. Fiduciary Duty as a Perceived Barrier to Change

In the trusts law context, fiduciary duty exists to protect the interests of beneficiaries. Fiduciary duty arose in medieval England to protect the property claims of minors against the avaricious intent of guardians; in modern pension funds, it protects beneficiaries' retirement funds from conflicts of interest with the trustees and asset managers who take care of the trust funds, as well as from their imprudence in investment. Paul Finn defines a 'fiduciary' as 'simply, someone who undertakes to act for or on behalf of another in some particular matter or matters.'⁴⁴ A person does not owe a fiduciary duty because he is a fiduciary. Rather it 'is because a particular rule applies to him that he is a fiduciary or confidant *for its purposes*.'⁴⁵ The duty arises out of a relationship of trust and confidence in which a trustee has power to exercise discretion affecting the interests of a beneficiary 'in a legal or practical sense'⁴⁶, and it holds the fiduciary to a higher standard of conduct

⁴¹ The concept of climate change was highly contested in the business community until recently. While the view that governments and business must address the problem of climate change is now accepted by the vast majority of governments and most businesses (for a contrarian view, *see generally*, BJORN LOMBORG, *COOL IT: THE SKEPTICAL ENVIRONMENTALIST'S GUIDE TO GLOBAL WARMING* (2007)), it is not surprising that aftershocks of the initial controversy continue to retard and confuse trustee decision-making on the topic. It is arguable, however, that any remaining controversy surrounding climate change is less contentious an issue for trustee decision-making than the breakdown of established financial wisdom following the financial crisis: *see e.g.*, *What Went Wrong with Economics*, *ECONOMIST*, July 18, 2009, at 11; Adair Turner, *How to Tame Global Finance*, *Features*, *PROSPECT MAGAZINE*, August 27, 2009.

⁴² *See, e.g.*, UNITED NATIONS ENVIRONMENT PROGRAM FINANCE INITIATIVE, *FIDUCIARY RESPONSIBILITY: LEGAL AND PRACTICAL ASPECTS OF INTEGRATING ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES INTO INSTITUTIONAL INVESTMENT* 32-46, 75 (2009) [hereinafter *UNEP FI, FIDUCIARY RESPONSIBILITY*]; *see generally*, *UNEP FI, A LEGAL FRAMEWORK FOR THE INTEGRATION OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES INTO INSTITUTIONAL INVESTMENT* (2005) [hereinafter *UNEP FI, LEGAL FRAMEWORK*]; PAUL PALMER ET AL, *SOCIALLY RESPONSIBLE INVESTMENT: A GUIDE FOR PENSION SCHEMES AND CHARITIES*, 97-103 (Charles Scanlan ed., 2005); RICHARDSON.

⁴³ *See* AXEL HESSE, *LONG-TERM AND SUSTAINABLE PENSION INVESTMENTS: A STUDY OF LEADING EUROPEAN PENSION FUNDS* (2008) (presenting results of surveys and interviews of a number of leading pension funds, which showed that most of these funds see fiduciary duty as a significant barrier to the inclusion of ESG factors in pension fund investment decision-making); *see also*, John Langbein & Richard Posner, *Social Investing and the Law of Trusts*, 79 *MICH. L. REV.* 72, 88-91, 96-104 (1980) (arguing that making investments for social or ethical reasons is generally contrary to pension funds' mandates); *see also*, Rosy Thornton, *Ethical Investments: a case of disjointed thinking*, *C.L.J.* 396, 397-99, 415 [2008] (arguing that SRI is 'of doubtful legality'); *UNEP FI, LEGAL FRAMEWORK*, *supra* note 42, at 7-8 (describing the perception of fiduciary duty regarding ESG issues in the UK).

⁴⁴ P.D. FINN, *FIDUCIARY OBLIGATIONS* 201 (1977).

⁴⁵ *Id.* at 2.

⁴⁶ *Hospital Products Ltd v. United States Surgical Corporation* 156 *CLR* 41, 96-7 (1984) (Austl.) (Mason J).

than that expected in normal business transactions.⁴⁷

The origin of the duty in the conscience-based courts of equity, long before it was known by the name ‘fiduciary duty’, gives it an inherently malleable quality. This was particularly so in medieval times – beneficiaries of a trust (or more accurately ‘use’, as it was then known) appealed to the Chancery courts with claims based in ethics or morality where they had no claim in common law (usually because the legal title to their property was in the hands of trustees).⁴⁸ In these cases, justice was sought to correct an affront to the conscience, and an appeal was made to the Chancellor’s moral and theological reasoning. Equity thus complemented the common law by providing justice in situations where the common law, which was restricted by precedent, could not. Those less charitable to the adaptable quality of equity regarded its development as *ad hoc*, with one prominent jurist complaining that ‘equity is as long as the chancellor’s foot’.⁴⁹ Fiduciary duty, like the rest of equity, evolved in a somewhat haphazard manner: why is it, asked Ernest Weinrib, two and a half centuries after the seminal case on fiduciary duty⁵⁰, that ‘certain categories of actors and certain types of acts are singled out for the application of the fiduciary standard and its attendant severe remedies?’⁵¹ The content and application of the duty have become clearer in recent years thanks to the introduction of legislation and academic work,⁵² including in the highly legislated area of pension funds and institutional investment.⁵³ As we will see, however, some significant uncertainties remain about pension fiduciary duty, particularly with respect to the consideration of non-financial factors in investment decision making.

This section first outlines fiduciary duty as it applies to pension funds in the US and the UK, examining the main duties⁵⁴ of loyalty and prudence (Part A). It then explores in detail why fiduciary duty has been found to prevent pension funds’ consideration of non-financial factors in decision-making in the past, considering the US cases *Board of Trustees v Mayor of Baltimore City*⁵⁵ and *University of Oregon v Oregon Investment Council*⁵⁶ and the UK case *Cowan v Scargill*⁵⁷ before looking at more recent legal developments in the US and UK (Part B). It is argued that the perceived danger of fiduciary consideration of non-financial issues has been construed too widely, setting the scene for the next stage of argument that the consideration of climate change as a risk or opportunity in most circumstances would not conflict with fiduciary duty. Finally, the scope for fiduciary duty to evolve is presented as paradoxical: fiduciary duty is flexible enough to adapt to evolving social expectations over time, but its prudence standard relies on reference to the investment decisions of fiduciaries’ peer group, meaning that the prudence standard encourages

⁴⁷ See *Meinhard v. Salmon* 164 N.E. 545 (N.Y. 1928), at 546 (opinion of Cardozo J) (‘Many forms of conduct permissible in a workaday world for those acting at arm’s length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honour the most sensitive is then the standard of behaviour’).

⁴⁸ See Donovan Waters QC, *The Trust: Continual Evolution of a Centuries-Old Idea* 14 J. INT’L. TRUST AND CORP. PLAN. 257, 258 (2007).

⁴⁹ *Id.*

⁵⁰ *Keech v. Sandford* 25 ER 223 (1726) (In this case, the defendant was required to hold a lease on constructive trust for an infant beneficiary).

⁵¹ Ernest J. Weinrib, *The Fiduciary Obligation* 25 U. TORONTO L.J. 1, 1 (1975).

⁵² See, eg Finn, *supra* note 44.

⁵³ John Langbein outlines the introduction of large amounts of legislation relating to fiduciary duty in the US investment context during the second half of the twentieth century: see John Langbein, *Why Did Trust Law Become Statute Law in the United States*, 58 ALABAMA L.R. 1069, 1069-71 (2007). Similarly, in the UK context, a number of acts have clarified fiduciary duty in the investment context, see e.g., Pensions Act 1995, the Trustees Act 2000.

⁵⁴ *Bristol & West Building Society v Mothew* Ch 1 (CA) [1998] at 18 per Millett LJ; see also Robert Flannigan, *The Fiduciary Obligation* 9 O.J.L.S. 285, 310 (1987).

⁵⁵ *Board of Trustees v. Mayor of Baltimore City* 317 Md. 72, 562 A.2d 720 (1989).

⁵⁶ *University of Oregon v. Oregon Investment Council* 82 Or. App. 145 (1987), 728 P.2d 30.

⁵⁷ *Cowan v. Scargill* Ch. 270 [1985].

conformity with convention and stifles innovation in the short term. As a result, it is argued that although fiduciary duty does not present a legal barrier to pension funds' consideration of climate change in most cases, in the absence of legislative clarification, it is likely that any move toward climate change consciousness will happen incrementally, in order to fulfil the conventionality requirements of the duty of prudence (Part C).

A. Fiduciary Duty in the Context of Pension Funds

The investment powers of trustees and asset managers of trust funds are limited by their legal obligations to the funds' beneficiaries. Pension funds in the common law world are generally set up as trusts. Pension fund trustees are entrusted with the role of maintaining the fund for the benefit of future pensioners (as beneficiaries). In addition to obligations under legislation, the trust deed, contract and the common law duty of care, trustees, and in most cases, asset managers,⁵⁸ are bound by fiduciary duty. Fiduciary duty originates from equity and trusts law, and today exists throughout the Anglo-American legal world in both case law and legislation.

Whereas pension fund trusts are similar in many ways to other trusts,⁵⁹ their peculiar intersection with other areas of law, especially employment law,⁶⁰ makes pension fund governance particularly complex. Graham Moffatt, writing in 1993, argued that the existence of the pension fund system within two spheres of law (trust law and employment law) led to inconsistencies in its regulation.⁶¹ Scott Donald has gone further, arguing that the regulation of pension funds is somewhat schizophrenic: the funds exist, traditionally, as trusts, but they have a second identity as investment vehicles, where beneficiaries are better conceived of as investors, and a third identity as private welfare providers to beneficiaries/citizens that have filled in a public service function of the retreating state.⁶²

In addition to these complexities, the content of pension fund fiduciary duty can vary according to jurisdiction⁶³. Bearing in mind these complexities and variations, the following two subsections outline the contents of fiduciary duty in the pension fund context in the the US and the UK. It presents the two central elements of trustee fiduciary duty: the duty of loyalty and the duty of prudence.

1. Duty of Loyalty: Primacy of beneficiary interests

The duty of loyalty establishes that fiduciaries must treat beneficiary interests as paramount in

⁵⁸ In the UK, the Trusts Act 2000 provides that agents are subject to the same duties as trustees when exercising trust powers. When it comes to asset management, trustees are required to detail the agency agreement with asset managers in writing (s. 13(1)) and to prepare a 'policy statement', which records how agents (eg asset managers) are required to exercise the powers that have been delegated to them (s. 13(2)). In the US, see ERISA, which provides that a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan: 29 U.S.C. § 1002(21)(A)(i)-(iii).

⁵⁹ *Cowan v Scargill* [1985] Ch 270 at 290 (judgment of Megarry VC).

⁶⁰ *Imperial Group Pension Trust Ltd v Imperial Tobacco Ltd* 1 WLR 589 [1991] at 597 (judgment of Browne-Wilkinson VC).

⁶¹ See Graham Moffatt, *Pension Funds: A Fragmentation of Trust Law* 56 M.L.R. 471, 488 (1993).

⁶² See Scott Donald, *Beneficiary, Investor, Citizen: Characterising Australia's Super Fund Participants*, 8 UNIV. N.S.W. LEGAL RESEARCH SERIES [2009] at 3.

⁶³ See Flannigan, *supra* note 54, at 310.

decision-making. It requires fiduciaries to act in the sole interests (or best interests, in certain contexts)⁶⁴ of the beneficiaries when exercising their discretion with respect to trust funds.⁶⁵ P.D. Finn's classic work in formulating general principles on fiduciary duty states that 'the general comments of the judges make it equally clear to what end [the fiduciary] must bend his exertions – the service of his beneficiaries' interests.⁶⁶ The duty of loyalty can include (but is not limited to) the following:

- fiduciaries must not put themselves in a position where their interests could conflict with those of a beneficiary;
- fiduciaries must not profit from their position as fiduciaries;
- fiduciaries must not misuse trust property.⁶⁷

Public pension funds in most US states are subject to the the *Uniform Prudent Investor Act (UPIA)*. The notes to section 5 of this Act state that 'the duty of loyalty is perhaps the most characteristic rule of trust law, requiring the trustee to act exclusively for the beneficiaries, as opposed to acting for the trustee's own interest or that of third parties.' *UPIA* provides that a 'trustee shall invest and manage the trust assets solely in the interest of the beneficiaries'.⁶⁸ A similar conception of the primary purpose of pension funds exists at common law in the various states.⁶⁹ Private pension funds in the US are governed by the *Employee Retirement Income Security Act 1974 (ERISA)*. *ERISA* provides that 'a fiduciary shall discharge his duties with respect to a plan solely in the interests of the participants and beneficiaries and ... for the exclusive purpose of (i) providing benefits to participants and their beneficiaries and (ii) defraying reasonable expenses of administering the plan.'⁷⁰

US law for both public and private pension funds clearly commences with a sole interest test, but a closer examination reveals that the standard can yield, on occasions, to other interests. John Langbein points out that while US law uses the sole interests of beneficiaries as a starting point for the duty of loyalty, the sole interests standard has been whittled away to a 'best interests' standard in a number of contexts, in particular commercial contexts.⁷¹ The reasoning behind the increasing number of exceptions to the sole interests standard is that 'the trust beneficiary will be better off if the law promotes the mutual advantage of trustee and beneficiary, in the fashion of other commercial relationships, than if it insist that only the beneficiary can benefit.'⁷² For example, *UPIA* allows pooled investment vehicles in order to facilitate adequate portfolio diversification, because a singular trust fund is often too small 'to diversify thoroughly by constructing its own portfolio of individually selected investments'⁷³. Similarly, US law allows trustees to be remunerated based on the rationale that 'the interest of trust beneficiaries as a class in obtaining the benefits of compensated trust services will more often be served by allowing the intrinsic conflict.'⁷⁴

In the UK, a best interests standard is generally applicable. Under the 2005 UK *Occupational*

⁶⁴ See John Langbein, *Questioning the Trust Law Duty of Loyalty* 114 *YALE L.J.* P 929, 963-987 (2005) and for the UK context see Occupational Pension Schemes (Investment) Regulations Cl. 4(2).

⁶⁵ See generally Langbein, *supra* note 64.

⁶⁶ Finn, *supra* note 44, at 15.

⁶⁷ See Flannigan, *supra* note 54, at 311.

⁶⁸ Unif. Prudent Investor Act (hereinafter *UPIA*) § 5.

⁶⁹ RESTATEMENT (THIRD) OF TRUSTS (1992).

⁷⁰ ERISA 29 USC §1104(a) (setting out the prudent standard of care).

⁷¹ See Langbein, *supra* note 64, at 968-978.

⁷² *Id.* at 969.

⁷³ *UPIA* § 3 cmt.

⁷⁴ See Langbein, *supra* note 64, at p 977.

Pension Schemes (Investment) Regulations, the trustee's foremost duty to beneficiaries is to act in their 'best interests', except in the case of a conflict of interest, when they must act 'in the sole interest of members and beneficiaries.'⁷⁵ The common law loyalty requirement in the UK is somewhat circular: UK trustees must exercise their investment powers 'fairly and honestly for the purposes for which they are given and not so as to accomplish any ulterior motive'.⁷⁶ The purposes of the investment powers are set out in the trust deed and rules.⁷⁷ The UK *Pensions Act 1995* requires trustees to create and maintain a 'statement of the principles governing decisions about investments for the purposes of the scheme'.⁷⁸ In cases involving pension funds, 'the best interests of the beneficiaries are normally their best financial interests,'⁷⁹ although there is some potential (discussed below) for pension fund trustees to consider non-financial factors relevant to beneficiaries interests⁸⁰.

The UK and US positions on the duty of loyalty both secure the interests of the beneficiaries, but in slightly different ways. In the US, the law recognises that in some instances, a slight compromise between interests results in best outcome of beneficiaries. By contrast, the UK approaches potential conflicts of interest by proscribing any compromise of beneficiary interests. The central focus of the duty of loyalty for both jurisdictions remains ensuring that fiduciaries who manage trust funds do not misuse their powers for dishonest gain at the expense of the beneficiaries. While both jurisdictions recognise wealth creation for beneficiaries as the pivotal role of trustees, in neither jurisdiction does the duty of loyalty require the untempered maximization of financial benefit for beneficiaries.⁸¹

2. Duty of Prudence: the modern prudent investor

In addition to the duty of loyalty, pension fund fiduciaries have a duty of prudence, or skill care and diligence. As this duty will be discussed in detail in subsection C of this section, this subsection simply sets out the nature of the duty in the US and UK.

In the United States, prior to the advent of modern portfolio theory, the classic statement of the prudence test for trustees is found in *Harvard v Amory*, which states that a trustee must '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'⁸²

Since the advent of modern portfolio theory⁸³, US pension funds' duty of prudence has been found in variations of the 'modern prudent investor rule': in ERISA (for private pension funds) and in UPIA (for almost all public pension funds), and in the Third Restatement of Trusts. Put briefly, the modern prudent investor rule requires prudent investment across a whole portfolio in the best

⁷⁵ Occupational Pension Schemes (Investment) Regulations Clause 4(2).

⁷⁶ *The Duke of Portland v. Lady Topham* 11 HL Cas 32 (1864) at 54.

⁷⁷ *See Harries v. Church Commissioners for England* 1 WLR 1241 [1992] at 1246.

⁷⁸ *See* section 35.

⁷⁹ *Cowan v. Scargill* 1 Ch. 270 [1985] at 287 (judgment of Megarry VC).

⁸⁰ *See Martin v. City of Edinburgh District Council* SLT 329 [1988]. In this case, Murry LJ questioned Megarry VC's strong statement for purely financial considerations, saying 'I cannot conceive that trustees have an unqualified duty simply to invest trust funds in the most profitable investment available. To accept that without qualification would, in my view, involve substituting the direction of financial advisers for the discretion of trustees.' Similarly, in *Harries v. Church Commissioners for England* 1 WLR 1241 [1992] at 1242 it was found that trustees 'must not use property held by them for investment purposes as a means for making moral statements at the expense of the charity of which they are trustees', but that this did not prevent them from acting as 'responsible shareholders'.

⁸¹ This is discussed in section B below.

⁸² *Harvard College v. Amory* (1830) 26 Mass. (9 Pick.) at 461.

⁸³ *See* the Uniform Prudent Investor Act, comment to § 5.

interests of the beneficiaries and for the purposes of the fund.

With respect to private pension funds, ERISA's modern prudent investor rule requires fiduciaries to discharge their duties '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.'⁸⁴ Fiduciaries must do so 'by diversifying the investments of the plan so as to minimise the risk of large losses, unless under the circumstances it is clearly prudent not to do so,'⁸⁵ and must act 'in accordance with the documents and instruments governing the plan.'⁸⁶

US public pension funds are governed by the laws of their state. Most US states⁸⁷ have now adopted UPIA, which is an attempt to codify the common law prudent investor rule in each state jurisdiction. UPIA uses language taken mainly from the Third Restatement of Trusts. UPIA's modern prudent investor rule requires trustees to 'invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.'⁸⁸ In keeping with modern portfolio theory, a 'trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.'⁸⁹

In the UK, a trustee must manage the trust in the same manner as an ordinary prudent man of business would conduct his own affairs.⁹⁰ Under the UK *Trustee Act* 2000, all trustees are required to 'exercise such care and skill as is reasonable in the circumstances', having regard to 'any special knowledge or experience that he has or holds himself out as having'⁹¹. Therefore professional trustees and asset managers purporting to have special fund management skills have a higher standard of care.⁹²

The *Pensions Act* 1995 requires pension funds to create a written statement of investment principles.⁹³ Its subordinate regulations, the *Occupational Pension Schemes (Investment) Regulations* 2005 specifies that pension funds must obtain advice from a qualified person prior to preparing or revising the statement of principles⁹⁴ and ensure adequate portfolio diversification⁹⁵. Pension fund trustees' investment powers must be 'exercised in a manner calculated to ensure the security, quality liquidity and profitability of the portfolio as a whole.'⁹⁶

⁸⁴ ERISA, 29 USC § 1104(a)(B).

⁸⁵ ERISA, 29 USC § 1104(a)(C).

⁸⁶ ERISA, 29 USC § 1104(a)(D) ('insofar as such documents and instruments are consistent with the [other] provisions' of ERISA.)

⁸⁷ At the time of publication of this article, 48 US states (all except Delaware and Mississippi) as well as the District of Columbia, had adopted UPIA. See: Michael E. Hunter, *Prudent Investor Rule – Risk Management Update*, available at <http://prudentinvestor-trustee.com/jurisdictions.html>.

⁸⁸ UPIA § 2(a).

⁸⁹ UPIA § 2(b).

⁹⁰ *Speight v. Gaunt* 9 App Cas 1 (1883) (HL) at 19 (judgement of Lord Blackburn) (approving 22 ChD 727 at 739–740, CA, per Jessel MR); *Re Whiteley*, *Whiteley v. Learoyd* (1886) 33 ChD 347 (CA) at 355 (Lindley LJ).

⁹¹ *Trustee Act* 2000 § 1(1)(a).

⁹² See also *Barlett v. Barclays Bank Trust Co Ltd* Ch 515 [1980] at 534.

⁹³ See *Pensions Act* 1995, ss 35-36.

⁹⁴ See *Occupational Pension Schemes (Investment) Regulations* 2005 Cl. 2(2)(a)

⁹⁵ Cl. 4(7).

⁹⁶ Cl. 4(3).

B. Pension Fund Fiduciary Duty and Non-Financial Considerations

The fiduciary duties of loyalty and prudence have often been seen as presenting an impediment to the consideration of so-called non-financial factors, in particular ethical, environmental, social and governance (ESG) factors in investment strategy.⁹⁷ This subsection discusses why non-financial factors have been seen as off-limits for pension fund fiduciaries: briefly, the duty of loyalty has on occasion been interpreted as requiring fiduciaries to focus solely on immediate financial returns from investments; courts have at times interpreted the duty of prudence in such a way as to encourage fiduciaries to adhere to the status quo, discouraging innovation in investment (including looking to factors other than traditional financial considerations). Critics oppose the consideration of non-financial issues on the basis that such consideration may indulge the political motives of trustees at the expense of financial earnings for beneficiaries.⁹⁸ Public pension funds, in particular, may be vulnerable to ill-judged, politically-motivated investment decisions.⁹⁹ This reasoning, if applied to climate change, paints pension funds' inclusion of climate change in investment strategy as contrary to fiduciary duty, at least in so far as its inclusion is unconventional compared with industry peers.

Part of the reason for the perpetuation of the perception that fiduciaries should not have regard to non-financial factors in their investment approach is the lack of recent case law directly on point. The main cases in both the US and the UK were decided in the 1980s, and in both places, the questions usually had to do with ethical and political questions regarding investment in then-apartheid South Africa. No case has tested the issue of whether specifically environmental factors may be taken into account in pension fund investment decisions. Certainly, no case has yet dealt with the question of whether pension fund investment strategy may have regard to climate change.

There have been recent attempts to clarify the status of non-financial considerations in pension fund investment strategy on both sides of the Atlantic. Unfortunately, neither country has succeeded. In the US, recent Department of Labor Bulletins intended to clarify the Department's position have in fact confused the issue further. Some commentators from within the institutional investment industry have interpreted the bulletins as requiring strict avoidance of non-financial consideration in investment decision-making¹⁰⁰; many regard them simply as confused, confusing and contradictory¹⁰¹. In the UK, comments from parliamentary debate in 2008 indicated some support for the view that ESG factors may legally be integrated into pension funds' investment strategies.¹⁰² However, no legislative change was made, and as a result the comments are in no way binding.

For these reasons, the uncertainty surrounding the requirements of fiduciary duty with respect to non-financial considerations remains, and creates a perception amongst trustees that it is safest not to test these waters. Without legislative clarification, it is likely that many pension funds will avoid

⁹⁷ See PALMER ET AL., *supra* note 42 at 79; Richardson, *supra* note 15 at 206; see also HESSE, *supra* note 43; see also, Langbein & Posner, *supra* note 43 at 96-104.

⁹⁸ See e.g., Jon Entine, *US Investment Funds and Fiduciary Irresponsibility*, ETHICAL CORPORATION January 16, 2004; Andrew Sheen, *Walk the Line*, GLOBAL PENSIONS, 26 November 2008 (citing the example of Connecticut public pension funds' decision to invest in an large but ailing local employer, Colt, in 1990, to save the company from bankruptcy. The plans lost \$21 million of a combined \$25 million investment within two years.)

⁹⁹ See Sheen, *supra* note 99.

¹⁰⁰ See Peter Kinder, "Rigid Rule" on Economically Targeted Investments: New ERISA Regulations on a Plan's "Economic Interests", *KLD Blog*, 25 November 2008, available at: <http://blog.kld.com/uncategorized/rigid-rule-on-economically-targeted-investments-new-erisa-regulations-on-a-plan-s-economic-interests/>.

¹⁰¹ Lisa Woll, CEO, & Cheryl Smith, Board Chair, Social Investment Forum, *Letter to Bradford P Campbell, Assistant Secretary, Employee Benefit Security Administration, US Department of Labor*, 19 December 2008. Available at <http://www.socialinvest.org/news/releases/pressrelease.cfm?id=129>.

¹⁰² Lord McKenzie of Luton, Hansard, House of Lords, 10 October 2008, column 917.

the issue altogether by ignoring the question of climate change.

1. US Case Law and Recent Commentary

US cases considering trustees' regard to non-financial factors in investment decision-making have produced mixed outcomes. In *Board of Trustees of Employee Retirement System of the City of Baltimore v City of Baltimore*,¹⁰³ the City of Baltimore had passed ordinances requiring the city's public pension funds to divest from companies that had business dealings in South Africa. The trustees of the funds sued the City, arguing that the ordinance restricted their ability to properly diversify by reducing their investment universe.¹⁰⁴ This, they argued, unlawfully affected their duty of prudence.¹⁰⁵ The trustees also argued that the ordinances unlawfully affected the common law duty of loyalty by diluting the trustees' focus on the exclusive benefit of beneficiaries through the inclusion of social considerations.¹⁰⁶

The Court of Appeal found that although the ordinances did reduce somewhat the universe of potential investments for trustees, 'a diversified, [South Africa Free] portfolio can be managed consistently with the duty of prudence'.¹⁰⁷ Furthermore, the court did 'not believe that a trustee necessarily violates the duty of loyalty by considering the social consequences of investment decisions.'¹⁰⁸ Instead, the court stated that 'a trustee's duty is not necessarily to maximize the return on investments but rather to secure a "just" or "reasonable" return while avoiding undue risk.'¹⁰⁹

By contrast, in *University of Oregon v Oregon Investment Council*¹¹⁰, the Court of Appeal of Oregon refused standing to the University of Oregon students associations who sought a declaration that the state could not invest endowment funds in companies operating in Namibia, South Africa and Zimbabwe. The students had challenged the Oregon Attorney-General's view that such divestment amounted to a probable violation of fiduciary duty. The court stated that the students 'do not allege any legally recognized injury, and neither agreement with plaintiffs' opposition to apartheid nor the desirability of encouraging students to become concerned with social and moral wrongs and to seek to right them can turn the alleged "injuries" into legally recognized ones.'¹¹¹

The findings in these two cases (as well as other contemporaneous cases¹¹²) suggests that whether or not non-financial considerations are permissible depends on the specific facts at hand. Surprisingly, there have been no significant recent US legal decisions to shed further light on these questions.

Contradictory views about the status of non-financial considerations also appear in US commentary surrounding the issue of non-financial considerations in pension fund investment. The comments to section 5 of UPIA, which applies to public pension funds in almost all states, say that

no form of so-called "social investing" is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries – for example, by accepting below-market

¹⁰³ Bd. of Tr. of Employee Ret. Sys. of City of Baltimore v. City of Baltimore 317 Md. 72 (1989); 562 A.2d 720.

¹⁰⁴ Bd. of Tr. of Employee Ret. Sys. of City of Baltimore v. City of Baltimore 317 Md. 72 (1989) at 103.

¹⁰⁵ Bd. of Tr. of Employee Ret. Sys. of City of Baltimore v. City of Baltimore 317 Md. 72 (1989) at 103.

¹⁰⁶ Bd. of Tr. of Employee Ret. Sys. of City of Baltimore v. City of Baltimore 317 Md. 72 (1989) at 102.

¹⁰⁷ Bd. of Tr. of Employee Ret. Sys. of City of Baltimore v. City of Baltimore 317 Md. 72 (1989) at 104.

¹⁰⁸ Bd. of Tr. of Employee Ret. Sys. of City of Baltimore v. City of Baltimore 317 Md. 72 (1989) at 109.

¹⁰⁹ Bd. of Tr. of Employee Ret. Sys. of City of Baltimore v. City of Baltimore 317 Md. 72 (1989) at 107.

¹¹⁰ Univ. of Oregon v Oregon Inv. Council 82 Or. App. 145 (1987), 728 P.2d 30.

¹¹¹ Univ. of Oregon v Oregon Inv. Council 82 Or. App. 145 (1987), 728 P.2d 30 at 150.

¹¹² See e.g., Blankenship v. Boyle, 329 F. Supp. 1089 (D.D.C. 1971); Withers v. Teachers' Ret. Sys. of City of N.Y., 447 F. Supp. 1248 (S.D.N.Y. 1978).

returns – in favor of the interests of the persons supposedly benefited by pursuing the particular social cause.¹¹³

The UPIA comment suggests that there can be no trade-off between financial and non-financial gains in pension fund investment strategies. By contrast, the US Department of Labour’s position vis-a-vis non-financial considerations by private pension funds is less clear. In 1998, the Department stated that fiduciary duties under ERISA

do not preclude consideration of collateral benefits, such as those offered by a ‘socially-responsible’ fund, in a fiduciary’s evaluation of a particular investment opportunity. However, the existence of such collateral benefits may be decisive only if the fiduciary determines that the investment offering the collateral benefits is expected to provide an investment return commensurate to alternative investments having similar risks.¹¹⁴

Then, on 17 October 2008, the Department released two interpretive bulletins that further muddied its stance on non-financial considerations in institutional investment. The first bulletin provides ‘supplemental guidance relating to fiduciary responsibility in considering economically targeted investments’¹¹⁵ (‘the ETI bulletin’). The second bulletin provides clarification on ‘the exercise of shareholder rights and written statements of investment policy, including proxy voting policies or guidelines’¹¹⁶ (‘the shareholder rights bulletin’). The bulletins are intended to reiterate and clarify the Department of Labor’s ‘longstanding view that workers’ money must be invested and used solely to provide for retirements and not for political, corporate or other purposes’.¹¹⁷

The ETI bulletin states that ERISA

establishes a clear rule that in the course of discharging their duties, fiduciaries may never subordinate the economic interests of the plan to unrelated objectives, and may not select investment on the basis of any factor outside the economic interest of the plan.¹¹⁸

However, where two or more alternative investments ‘are of equal economic value’, fiduciaries are permitted to ‘choose between the investment alternatives on the basis of a factor other than the economic interest of the plan’.¹¹⁹ The bulletin highlights the Department of Labor’s belief that fiduciaries who rely on non-economic factors to make investment decisions will find it difficult to prove compliance with ERISA ‘absent a written record demonstrating that a contemporaneous economic analysis showed the investment alternatives were of equal value’.¹²⁰

The shareholder rights bulletin states that the fiduciary duties described in ERISA require that

in voting proxies, regardless of whether the vote is made pursuant to a statement of investment policy, the responsible fiduciary shall consider only those factors that relate to the economic value of

¹¹³ UPIA, comments to § 5.

¹¹⁴ Letter from the Department of Labor to William M. Tartikoff, Senior Vice President and General Counsel of Calvert Group Ltd. (May 28, 1998) [hereinafter Calvert Letter].

¹¹⁵ Employee Benefits Security Administration, *Interpretive Bulletin Relating to the Fiduciary Standard under ERISA in Considering Economically Targeted Investments*, 29 CFR §2509.08-1 (hereinafter ‘ETI bulletin’).

¹¹⁶ Employee Benefits Security Administration, *Interpretive Bulletin Relating to Exercise of Shareholder Rights*, 29 CFR §2509.08-2 (hereinafter ‘shareholder rights bulletin’).

¹¹⁷ Employee Benefits Security Administration, News Release n. 08-1448-NAT, *U.S. Department of Labor Updates Fiduciary Guidance on Exercising Shareholder Rights and Investing in Economically Targeted Investments*, October 16, 2008.

¹¹⁸ The ETI bulletin, *supra* note 116.

¹¹⁹ *Id.*

¹²⁰ *Id.*

the plan's investment and shall not subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives.¹²¹

The shareholder rights bulletin also reinforces that all proxy voting guidelines in statements of investment policy must comply with fiduciary duty. As such, these 'may not subordinate the economic interests of the plan participants to unrelated objectives.'¹²²

While Department of Labor bulletins are only binding upon pension funds that are governed by ERISA and do not affect general trust law, they are nonetheless likely to influence judicial interpretation.¹²³ Shortly after the publication of the bulletins, the Social Investment Forum, ('SIF'), wrote an open letter to the Department criticizing inconsistencies and ambiguities in the bulletins' language.¹²⁴ The bulletins appear to have confused, rather than clarified, the US Department of Labor's views with respect to the inclusion of financial factors in decision-making.

In short, US legal cases, legislation and Department of Labor commentary present pension funds with unclear guidance about their obligations with respect to the consideration of non-financial issues in investment strategy.

2. UK Case Law and Recent Commentary

The case that has had the greatest influence, somewhat undeservedly, on the issue of non-financial considerations in pension fund investment decisions in the UK is *Cowan v Scargill*¹²⁵. In that case, the five Board-appointed trustees of the Mineworkers' Pension Scheme sued the other five (union-appointed) trustees over their refusal to agree to an investment plan unless it was amended 'so as to prohibit any increase in overseas investment, to provide for the withdrawal of existing overseas investments at the most opportune time, and to prohibit investment in energies which are in direct competition with coal'¹²⁶. The Court found that the union trustees were in breach of their fiduciary duty in refusing to accept the diversified investment plan. Megarry VC held that:

When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests.¹²⁷

He went on to explain that trustees must put aside their social, political and moral views when making investment decisions on behalf of the trustees:

In considering what investments to make trustees must put on one side their own personal interests and views. Trustees may have strongly held social or political views. They may be firmly opposed to any investment in South Africa or other countries, or they may object to any form of investment in companies concerned with alcohol, tobacco, armaments or many other things. In the conduct of their own affairs, of course, they are free to abstain from making any such investments. Yet under a trust, if investments of this type would be more beneficial to the beneficiaries than other investments, the trustees must not refrain from making the investments by reason of the views that they hold.¹²⁸

Pension funds have often cited this case demonstrating that the 'best interests' of beneficiaries

¹²¹ The shareholder rights bulletin, *supra* note 117.

¹²² *Id.*

¹²³ *See* Kinder, *supra* note 100.

¹²⁴ *See* Woll & Smith, *supra* note 101.

¹²⁵ Ch. 270 [1985].

¹²⁶ *Cowan v. Scargill* Ch. 270 [1985] at 276-7.

¹²⁷ *Cowan v. Scargill* Ch. 270 [1985] at 287.

¹²⁸ *Cowan v. Scargill* Ch. 270 [1985] at 287-8.

coincide with their financial interests and that non-financial considerations are likely to breach fiduciary duty. Therefore, the belief that trustees must seek to maximise profit at the expense of all other considerations has held currency with many institutional investors.¹²⁹ However, this interpretation has been challenged.

A number of commentators, including Megarry VC himself, have argued that the *Cowan v Scargill* decision has been overly influential and has been interpreted too widely. Writing in an academic paper in 1989, Megarry expressed surprise at amount of attention his decision had received¹³⁰ (that was twenty years ago, and the decision is still the primary case on the matter). This view was reinforced in *Martin v City of Edinburgh District Council*,¹³¹ in which Lord Murray said ‘I cannot conceive that trustees have an unqualified duty ... simply to invest trust funds in the most profitable investment available’¹³².

Under the *Occupational Pension Schemes (Investment) Regulations 2005*, a pension fund’s statement of investment principles must detail ‘the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments’¹³³. On 7 October 2008, the UK legislature debated whether legislation should go further and establish a general rule that certain non-financial issues could inform pension fund investment decision-making. In speaking about a proposed amendment to the *Pension Bill*, Lord McKenzie stated that ‘there is no reason in law why trustees cannot consider social and moral criteria in addition to their usual criteria of financial returns, security and diversification’.¹³⁴ Lord McKenzie went on to say that:

It follows from this that it may be appropriate for trustees to engage in these considerations with companies in which they invest. This may include disinvesting from such companies if, acting in accordance with their fiduciary duties and the objects of their trust, they consider that this is right and in the best interests of their members.¹³⁵

These comments were not, however, followed by any legislative clarification of the issue in the UK. Indeed, they were intended to demonstrate that no legislative sanctioning of socially driven investing was necessary, with Lord McKenzie going on to say:

It would not be appropriate for the Government or Parliament to impose any guidelines that might restrict the trustee’s independence in carrying out its overriding duty to members, although governments have a role in engendering a climate which fosters ethical investment and in ensuring that legislation does not act as a barrier to those who are committed to this.¹³⁶

In 2005, the United National Environment Program Finance Initiative (UNEP FI) released a report that examined the issue of institutional investors’ treatment of ESG factors in investment decision-making. The report surveyed the legal landscape in both common law and civil law jurisdictions and came to the conclusion that:

It is not a breach of fiduciary duties per se to have regard to ESG considerations while pursuing the purposes of the trust. Rather, in our opinion, it may be a breach of fiduciary duties to fail to take

¹²⁹ UNEP FI, LEGAL FRAMEWORK, *supra* note 42 at 3, 6, 9, 27-28, 82, 88.

¹³⁰ Robert Megarry, *Investing Pension Funds: The mineworkers’ case*, T.G. YODAN, EQUITY, FIDUCIARIES AND TRUSTS 115 (1989).

¹³¹ SCLR 90 [1988].

¹³² SCLR 90 [1988] at 334.

¹³³ Cl. 3(b)(vi).

¹³⁴ Lord McKenzie of Luton, *supra* note 102.

¹³⁵ *Id.*

¹³⁶ *Id.*

account of ESG considerations that are relevant and to give them appropriate weight, bearing in mind that some important economic analysts and leading financial institutions are satisfied that a strong link between good ESG performance and good financial performance exists.¹³⁷

Despite the sanguine views of UNEP FI, no recent case law nor legislation has appeared to confirm or deny either their assertions or those of Lord McKenzie. Nor has the US Department of Labor's recent commentary been tested. With the recent entrance of the Obama administration, it is possible that the commentary will undergo further change before there is an opportunity for it to be tested. Therefore, the legal position with respect to pension funds' consideration of non-financial factors in investment strategy remains unclear in both the US and the UK. As the law currently stands, the inclusion of climate change as a factor in investment decision-making may perfectly acceptable. On the other hand, it may put pension funds at risk of violating their fiduciary obligations: until legislation or case law clarifies the point, funds will not know. And, until the advent of either a legal case or legislation confirming that environmental considerations such as climate change may form part of pension funds' investment decision-making, pension funds will be wary of amending their investment strategies. It is this uncertainty, rather than fiduciary duty itself, that acts as an impediment to the consideration of non-financial factors at present.

C. Fiduciary Duty's Paradox: Incrementally flexible

The above section has demonstrated that the uncertainty surrounding pension funds' obligations with respect to non-financial factors in investment decision-making presents a practical barrier to consideration of environmental factors, including climate change, in both the US and UK context. It is clear that part of the problem is the lack of both current case law and consistent legislative commentary on the topic. However, the problem runs deeper than that – it is tied to the nature of fiduciary duty itself. This subsection examines what it is about fiduciary duty that makes it ill-suited to adapt to changing social circumstances in anything other than an incremental manner. The urgent nature of climate change makes this situation all the more poignant.

Fiduciary duty is a ramshackle concept. In early case law it arose, organically, out of certain relationships of trust. Whether a particular relationship was fiduciary, and what duty it entailed, was often difficult to predict.¹³⁸ Indeed, it is difficult to escape the perception that in early times the finding of fiduciary duty, and its content, was rather arbitrary.¹³⁹ The preceding sub-sections have demonstrated that although the nature of pension fund fiduciary duty has been clarified in both the US and the UK by successive pieces of legislation, uncertainties remain, particularly with respect to non-financial factors in investment decisions. And, as Langbein has argued, elements of the duty continue to evolve, both through legislation¹⁴⁰ and through curial interpretation.¹⁴¹ In short, pension fund fiduciary duty remains, to an extent, 'a concept in search of principle'¹⁴².

¹³⁷ UNEP FI, FIDUCIARY RESPONSIBILITY, *supra* note 42, at 100.

¹³⁸ See e.g., RICHARD CLEMENTS & ADEMOLA ABASS, EQUITY AND TRUSTS: TEXTS, CASES, AND MATERIALS (2008) ('The most common fiduciary relationships exist between trustees and beneficiaries, agents and principals, directors and companies and partners and co-partners'); Sealy, *Fiduciary Relationships*, CAMBRIDGE L.J. 69 [1962] at 73 (outlining four categories of fiduciary duty).

¹³⁹ See KIRSTEN EDWARDS, ESSENTIAL EQUITY AND TRUSTS 88 (2005, 2nd ed) (arguing that fiduciary duty was plagued by uncertainty for a number of reasons, including 'wide indicia for finding a fiduciary relationship, the necessity of flexibility in the approach of courts and the subjective notions of public policy and good conscience which underlie decision making'); see also L. S. Sealy, *supra*, note 138, at 73.

¹⁴⁰ See Langbein, *supra* note 53, at 1070-71, 1077-78.

¹⁴¹ *Id.* at 968-71.

¹⁴² Sir Anthony Mason, *Themes and Prospects* in P.D. FINN (ED.), ESSAYS IN EQUITY 246 (1985).

In order to deal with the changing social and environmental realities associated with climate change, fiduciary duty must be able to accommodate certain investment innovations – in particular to allow the consideration of climate change. It must be able to recognise the transition of climate change from a non-financial factor to a financial factor, as legislation (e.g. on emissions trading) and markets are gradually doing. However, this subsection argues that while this type of innovation in fiduciary duty is possible, without legislative change it will be incremental – and too slow to meet the urgent changes required by climate change.

This subsection explores the paradoxical nature of fiduciary duty with respect to investment innovation: the duty can evolve – history has seen it adapt to emerging social expectations – but the tendency for courts to judge fiduciaries’ prudence by reference to existing investment norms means that any innovation in investment is bound to be incremental – any change in fiduciary duty must fight against considerable inertia. As a result, while the past flexibility of fiduciary duty suggests that the investment innovation of considering climate change is acceptable in theory, the past also suggests that innovation in the courts (that is, absent legislation), is incremental. Change, when introduced too quickly, has been equated by courts with imprudence in the past. The following subsections visit fiduciary duty’s incrementally adaptable nature, showing how it has adapted to evolving financial and social norms in the past (subsection 1), but also discussing its tendency toward inertia (subsection 2). The final subsection discusses what the nature of fiduciary duty means for pension funds’ attitudes toward climate change (subsection 3).

1. Adapting to Changing Social Expectations (both Financial and Non-Financial)

Fiduciary duty in an investment context has adapted slowly to changing social expectations about finance over the years. If we trace the development of trustees’ fiduciary duty since Victorian times, the change in expectations of investment is striking. In the eighteenth and nineteenth centuries, English law took a prescriptive, risk-averse approach to the investment of trust funds. In *Learoyd v. Whitely*¹⁴³, Watson LJ explained the principle as follows

Business men of ordinary prudence may, and frequently do, select investments which are more or less of a speculative character; but it is the duty of the trustee to confine himself to the class of investments which are permitted by the trust and likewise to avoid all investments of that class which are attended with hazard.¹⁴⁴

According to John Langbein, early English legal attitudes toward investment of trust funds were deeply affected by the South Sea Bubble: in 1719, Parliament allowed trustees to invest in the South Sea Company, whose shares promptly dropped by 90 percent.¹⁴⁵ In the aftermath, the chastened Parliament instigated a conservative approach to investment of trust funds that began with the Bubble Act of 1719¹⁴⁶ and would not disappear completely until the Trustee Act 2000. Under this risk-averse approach, trustees were only permitted to invest in assets specifically authorised in legislation.¹⁴⁷ These generally included consolidated bank annuities, gilts and mortgages of real

¹⁴³ *Learoyd v. Whitely* 12 AC 727 (1887). In this case the trustees lost a significant sum of trust money by investing in the a mortgage of a brickfield that went broke.

¹⁴⁴ *Learoyd v. Whitely* 12 AC 727 (1887) at 733.

¹⁴⁵ John Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing* 81 IOWA L.R. 641, 643 (1996).

¹⁴⁶ 6 Geo., ch. 18 (Eng.) The Bubble Act prevented fiduciaries from investing in anything but consul bonds (government backed bonds). See Randall H. Borkus, *A Trust Fiduciary’s Duty to Implement Capital Preservation Strategies Using Financial Derivative Techniques*, 36 REAL PROP., PROBATE & TRUST J. 127, 130 (2001) (noting that Parliament’s restriction of trust investment to government bonds had the added attraction of ensuring that English trust funds stayed within England).

¹⁴⁷ The earliest of these was the Law of Property (Amendment Act) (Eng.) ‘Lord St Leonard’s Act’ of 1859, which was followed by further acts, including the Trust Investment Act 1889 and the Trustee Act 1925.

property.¹⁴⁸

The prescriptive nature of these legislative lists was gradually relaxed over time: under the Trustee Investment Act 1961, trust funds were required to be divided into ‘narrower range’ and ‘wider range’ investments,¹⁴⁹ with wider range investments including UK securities and some shares.¹⁵⁰ It was not until the repeal of the 1961 Act with the Trustee Act 2000 that the prescriptive approach to investment disappeared from English legislation, allowing trustees to invest in any asset class.

The law with respect to investment of trust funds in the US followed a similar trajectory. US law inherited the English system of prescribing suitable investments for trustees in Victorian times.¹⁵¹ It began to move away from the prescriptive approach with the seminal case, *Harvard v. Amory*, which introduced the classic US statement of the more flexible prudent man test:

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 probably income, as well as the probably safety of the capital to be invested.¹⁵²

While there was some resurgence of the process of requiring trustees to invest only in assets included on a ‘legal list’ of investment options for trustees following the New York case, *King v. Talbot*¹⁵³, legislative initiatives gradually broadened trustees’ investment opportunities throughout the nineteenth and twentieth centuries.¹⁵⁴ In particular, the advent of modern portfolio theory in the 1940s led to the legislative introduction of the modern prudent investor rule.¹⁵⁵ The large amount of legislative change regarding the investment of trust funds in the US is testament to the flexibility of fiduciary duty. As Langbein notes

the trust of today bears only a distant relationship to the trust of former centuries. The trust that we know is mainly a creature of the twentieth century; accordingly, common law processes of incrementalism were no more suitable for today’s trust law than for the regulation of nuclear power plants.¹⁵⁶

Today, under the modern prudent investor rule, trustees in the US may invest in any asset that is appropriate to the fund portfolio, taking into account the risk and return objectives of the trust and its beneficiaries.¹⁵⁷

The need for fiduciary duty to entertain new social and economic expectations surrounding investment was such that its adaption had to be facilitated by legislation. In this light, the past flexibility of fiduciary duty with respect to the investment of trust funds is demonstrated by its rapid adaptation to new financial standards. The potential for fiduciary duty to adapt to new investment

¹⁴⁸ Paulo Panico, *Trustee Investment Powers in International Trust Law* 15 TRUSTS & TRUSTEES 96, 97 (2009).

¹⁴⁹ Trustee Investment Act 1961, § 2.

¹⁵⁰ *See Id.* sched. III.

¹⁵¹ Langbein, *supra* note 53, at 1077-8.

¹⁵² *Harvard College v. Amory* 26 Mass. (9 Pick.) (1830) at 461.

¹⁵³ *King v. Talbot* 40 N.Y. 76 (1869). The New York courts interpreted the investment powers of trustees narrowly, restricting them to statutory lists: *see* MARK L. ASCHER, SCOTT AND ASCHER ON TRUSTS §19.1.2. (2007, 5th ed).

¹⁵⁴ *See* Fredric J. Bendremer, *Modern Portfolio Theory and International Investments under the Uniform Prudent Investor Act* 35 REAL PROP. PROB. & TR. J. 791, 797 (2001); Langbein, *supra* note 138, at 643.

¹⁵⁵ Langbein, *supra* note 145, at 644.

¹⁵⁶ John Langbein, *supra* note 53, at 1071.

¹⁵⁷ *See* Uniform Prudent Investor Act § 2(e) (‘A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act]’).

approaches is therefore clear. Taking these points one step further, the next paragraphs argue that fiduciary duty also has the flexibility to adopt a broader view of investment by allowing the consideration of certain non-financial issues in investment decision-making.

Changing societal expectations have affected fiduciary duty's approach to investment in subtler ways than risk averseness. Fiduciary duty has had the flexibility to evolve with respect to non-financial factors in trustee decision-making in the context of changing attitudes toward women in the work place. Although dealing with trustees of a council rather than those of a pension fund, *Roberts v. Hopwood*¹⁵⁸ provides a vibrant illustration of how fiduciary duty can evolve in a social context. In this case, a local authority used its powers under statute¹⁵⁹ to increase wages for its workers to above the national average and to pay men and women equally. The district auditor found that the council's wage increase was unreasonable and ordered its reversal.¹⁶⁰ The council appealed and the case progressed to the House of Lords. The House of Lords found that the council had breached its fiduciary duty by aiming to be a model employer instead of paying the minimum wage. Atkinson LJ stated that

the council would, in my view, fail in their duty if, in administering funds which did not belong to their members alone, they put aside [minimum wage indicators] and allowed themselves to be guided in preference by some eccentric principles of socialistic philanthropy, or by a feminist ambition to secure the equality of the sexes in the matter of wages in the world of labour.

Atkinson LJ regarded the council's decision to increase wages for both men and women as a symptom of 'the vanity of appearing as model employers of labour' and of the council becoming 'such ardent feminists as to bring about, at the expense of the ratepayers whose money they administered, sex equality in the labour market.'¹⁶¹ In this case, the council's consideration of non-financial factors in determining how to invest ratepayers' money was found to violate its fiduciary duty to ratepayers.

With the growth of the anti-discrimination movement throughout the twentieth century, the decision to grant wage parity between sexes no longer appears to be the fanciful indulgence of 'some eccentric principles of socialistic philanthropy'. Some sixty years later, in *Pickwell v Camden London Borough Council*¹⁶², the Court affirmed the fiduciary duty of a council to its ratepayers, but also noted the council's entitlement to ensure the welfare of its workers, stating that the council 'must therefore often be involved in balancing fairly these interests which may frequently conflict.'¹⁶³ The Court referred to the decision of the House of Lords in *Roberts v Hopwood* and said

looking back, as we do, over 60 years of progress in the field of social reform and industrial relations some of their Lordships' observations may, with the benefit of this hindsight, appear unsympathetic... what has changed over those years is our attitudes to what should be regarded as pure philanthropy.¹⁶⁴

In other words, whereas wage parity was once seen as philanthropy, it is now seen as a legitimate consideration potentially consistent with fiduciary duty. The Court's comments with respect to *Roberts v Hopwood* indicate an acknowledgment of the flexibility of fiduciary duty to yield in

¹⁵⁸ *Roberts v. Hopwood* AC 578 [1925].

¹⁵⁹ Metropolis Management Act 1855, § 62.

¹⁶⁰ *Roberts v. Hopwood* AC 578 [1925] at 590-1.

¹⁶¹ *Roberts v. Hopwood* AC 578 [1925] at 591-2.

¹⁶² *Pickwell v. Camden London Borough Council* QB 962 [1983].

¹⁶³ *Pickwell v. Camden London Borough Council* QB 962 [1983] at 987 (judgment of Forbes J).

¹⁶⁴ *Pickwell v. Camden London Borough Council* QB 962 [1983] at 986 (judgment of Forbes J).

accordance with evolving social forces as well as commercial forces.¹⁶⁵ The development of fiduciary duty here was ancillary to the commercial context: just as the duty has adapted to evolving expectations in the investment context, it has also adapted to admit considerations once considered to be non-financial. It is therefore possible that fiduciary duty could adapt to changing social expectations about the environment, and in particular climate change. It is important to remember that fiduciary duty, no matter how immutable it appears to be at a single moment in time, is and always will be the object of interpretation; how it will be interpreted will vary with evolving investment and social standards. It is the *rate* of its evolution that is uncertain, an idea that is discussed below.

2. Inherent Inertia: Prudence tends toward the status quo

While the content of fiduciary duty clearly can evolve over time, change is often slow. It took more than 250 years for the investment conservatism engendered by the South Sea Bubble to give way to the concept of diversified investment portfolios. In particular, the law lagged significantly behind the finance industry (and, it must be said, financial reality) in adopting modern portfolio theory.¹⁶⁶ It is argued here that legal inertia with respect to fiduciary duty and pension fund investment is linked to the prudent man standard.

What is prudence? According to the UK Pensions Regulator, ‘[p]rudence is difficult to define in general terms and will apply differently to different circumstances.’¹⁶⁷ Prudence is so difficult to define precisely because it is circumstantial. When judges are faced with deciding whether a particular trustee’s decision was prudent, both US and UK law requires them to look at what other trustees in a similar position would do – they must look to the conventional behaviour in the pension fund industry. In 2000, Hawley and Williams argued that ‘the safest course of action for a professional owner is to take *only* those actions generally accepted as prudent – which historically has led institutions to adopt a conservative view of their responsibilities as owners.’¹⁶⁸ The prudent course of action in this light becomes the status quo, slowing innovation in investment decision making. Therefore although fiduciary duty in the investment context is flexible, it is, paradoxically, susceptible to significant inertia. This is of great consequence for pension fund trustees, as it reinforces pre-existing behavioural biases within the industry (this problem is discussed in section IV below). This inertia comes from several quarters: legislation, incremental judicial interpretation, and through the behaviour of the pension fund industry itself.

In the US, a formula urging fiduciaries to perpetuate the status quo in investment behaviour is built into the modern prudent investor rule. Under the rule as it is formulated in ERISA, trust funds must be managed ‘with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.’¹⁶⁹ When determining how a prudent man in an investment context might act, it seems logical that investors should look to the investment behaviour of their peers – or at least to the behaviour of their peers that has not attracted criticism for imprudent investment. Fiduciaries are therefore encouraged to base their investment judgements

¹⁶⁵ It is possible that a similar change in the pension fund context would be more difficult to achieve than in the council context, because statutory requirements mean that councils have a wider stakeholder group than pension funds: *see* *Pickwell v. Camden London Borough Council* QB 962 [1983] at 987 (judgment of Forbes J).

¹⁶⁶ *See* Frank Finn & Peter Ziegler, *Prudence and Fiduciary Obligations in the Investment of Trust Funds* 7 AUSTL. L.J. 329, 337 (1987) (with respect to UK and Australian contexts). *See* Langbein, *supra* note 145, at 643-45.

¹⁶⁷ The Pensions Regulator (UK), Media Centre, *Questions and Answers: Scheme specific funding*. Available at: <http://www.thepensionsregulator.gov.uk/mediacentre/events/sfWorkshop/ssfQAanswers.aspx>.

¹⁶⁸ Hawley & Williams, *supra* note 29, at 168.

¹⁶⁹ *See* ERISA, 29 USC §18.1104.

essentially upon the prevailing investment conventions at any one time.

In the UK, a trustee must manage the trust in the same manner as an ordinary prudent man of business would conduct his own affairs.¹⁷⁰ Professional trustees and asset managers professing to have special fund management skills have a higher standard of care.¹⁷¹ The standard of care for both professional and other trustees is, like the US standard, self-referential. The prudence standard is once again associated with *what other investors do*. As such, UK pension fund trustees are expected to associate prudence with a conventional approach to investment.

A preference for maintaining the status quo in investment behaviour can be seen in the historical reluctance of many courts to accept modern portfolio investment as prudent. Prior to the introduction of the modern prudent investor rule, courts across the Anglo-American legal world required fiduciaries to be able to demonstrate that each individual investment is ‘prudent’ – any single investment failure could amount to imprudence on the part of the fiduciary. This legal stance resulted in risk-averse decisions by pension fund trustees, but also in returns that were significantly lower than they could have been.¹⁷² The introduction of the US modern prudent investor rule, and its equivalent diversification rule in the UK, allowed fiduciaries to make investments that were more beneficial for the beneficiaries. The ability of pension funds to adapt to the realities of climate change are similarly restrained by the prudence standard’s hostility to anything other than incremental change.

Judicial interpretation of the standard of prudence presents a further pressure on trustees to invest according to the convention of their day. Fratcher points out that

there is a tendency on the part of the courts even in the absence of a statute to lay down definite subsidiary rules on what is and what is not a prudent investment. When a certain investment is held in one case to be improper, the courts are likely to treat the case as a precedent holding that no investment of that type is proper.¹⁷³

It is this tendency that has made palpable the fear of pension fiduciaries of considering factors traditionally seen as non-financial in investment decision making; it is this tendency that allowed the judgment in *Cowan v Scargill* to grow to the (undeservedly) legendary proportions it has reached.

In the US, the testimony of experts in financial affairs is usually admissible for determining whether a fiduciary has acted prudently.¹⁷⁴ This self-referential feature is likely to propagate conventional wisdom, rather than to encourage trustees to innovate. The practical consequence of requiring investors to base their actions on the actions of their peers is that the status quo tends to prevail. For this reason, Keith Johnson and Frank Jan de Graf have described the prudence standard as a ‘lemming standard’.¹⁷⁵ In their view, ‘pension funds are often reluctant to pursue prudent strategies not being widely used by other pension funds for fear of exposure to liability’.¹⁷⁶ In circumstances

¹⁷⁰ *Speight v. Gaunt* 9 App Cas 1 at 19 (1883), HL, per Lord Blackburn (approving 22 ChD 727 at 739–740, CA, per Jessel MR); *Re Whiteley*, *Whiteley v. Learoyd* 33 ChD 347 (1886) at 355, CA, per Lindley LJ.

¹⁷¹ *Barlett v Barclays Bank Trust Co Ltd* Ch 515 [1980] at 534.

¹⁷² See Randall H. Borkus, *A Trust Fiduciary’s Duty to Implement Capital Preservation Strategies Using Financial Derivative Techniques*, 36 REAL PROP., PROBATE & TRUST J. 127, 129 (2001); See also Stephen P Johnson, Note, *Trustee Investment: The prudent person rule or modern portfolio theory, you make the choice* 44 SYRACUSE L. R. 1175, 1177 (1993).

¹⁷³ WILLIAM FRATCHER, *THE LAW OF TRUSTS (SCOTT ON TRUSTS)* 434-5, § 227 (1988, 4th ed).

¹⁷⁴ ASCHER, *supra* note 153, at 1396 §19.1.2.

¹⁷⁵ JOHNSON & DE GRAAF, *supra* note 1, at 5.

¹⁷⁶ *Id.* at 5.

such as the present, where investors are typically driven by short-term performance, prudent investment becomes short-term investment.

The situation in the UK is similar. A report published by the UK Department of Social Security in 1997 used in-depth interviews with trustees of 48 self-administered private sector occupational pension schemes to examine trustee investment practice. The report found that the main objective for trustees in administering their funds was to provide a good return on assets, and that trustees sought to achieve this aim by ‘appointing expert advisers and fund managers with successful track records and monitoring their performance; adopting what they perceive as cautious investment policies; and providing guidelines and benchmarks for fund managers for investing schemes’ assets.¹⁷⁷ In the UK, trustees who are unsure of their duty may take advice from experts, including those within the finance industry.¹⁷⁸

There have been some moves made toward encouraging pension fund trustees to act independently of their peers if their fund is different to the norm. In 1990, the Committee of Enquiry Report into Investment Performance Measurement recommended that ‘trustees should consider whether their own fund has special characteristics which indicate that it should be invested differently from the generality of funds.’¹⁷⁹ However, this does nothing to encourage innovation in a fund which does not have ‘special characteristics’.

3. The Outcome for Climate Change

The evolution of fiduciary duty, from restricting investment to specific low-risk categories until the second half of the twentieth century to embracing the modern prudent investor rule, reflects a change in social attitudes toward investment. Statutes in both the UK and the US are helping to keep fiduciary duty up to date – this is particularly true of the statutory shift from prescriptive lists of investment options for fiduciaries toward the modern prudent investor rule. However, even the statutory developments of the last two decades are insufficient to enable pension funds to move toward a more sustainable investment paradigm.¹⁸⁰ The incrementalism central to the maturation of fiduciary duty in the past cannot facilitate the urgent action required by climate change. Nor does it, more importantly, encourage a deep philosophical change of the kind necessary to look at the long-term sustainability of investments.

An aggravating factor exists here in the question of whether, and to what extent, a court would consider climate change a ‘non-financial’ issue. Until such a case is heard, or relevant legislation enacted, it will be difficult to displace fiduciaries’ anxiety with respect to the consideration of climate change within investment decision-making. It is reasonable to predict that courts will decide by reference to convention: if most pension funds view climate change as a non-financial issue, then courts are likely to see this position as the prudent one. While almost all governments and major companies around the world now see climate change as a financial issue, as well as an environmental and social one, few pension funds have demonstrated this view. In a way, therefore, pension fund inaction on climate change is likely also to be self-perpetuating without legislative clarification.

¹⁷⁷ C. PRATTEN & S. SATCHELL, PENSION FUND SCHEME INVESTMENT POLICIES, DSS Research Report No. 82 (1998).

¹⁷⁸ *Learoyd v Whiteley* 12 App Cas 727 (1887), HL, at 734 per Lord Watson.

¹⁷⁹ PRATTEN & SATCHELL, *supra* note 177.

¹⁸⁰ Also an insufficient catalyst for change is any move toward greater democratisation of pension fund governance: *cf* BENJAMIN RICHARDSON, *supra* note 15 at 246-254. Given the behavioural biases described below, as well as the barriers Richardson acknowledges, the idea that beneficiaries may be a viable means of imposing discipline on funds is no more than a liberal dream.

There is no intrinsic reason for fiduciary duty to prevent pension funds from adopting a forward-looking approach to investment that includes the consideration of factors (such as climate change) which are coming to be recognised as financial but which have not traditionally informed investment decisions. In theory, fiduciary duty should adapt to new economic realities engendered by climate change, but change is likely to be incremental (just as it was with respect to modern portfolio theory and equal opportunity in the past). Left up to pension fund trustees and courts, it is likely that the concept of prudence will lag behind as legislative changes correct the market failures of climate change. In practice, the tendency for prudent behaviour to be equated with conventional behaviour means that most pension funds will not move beyond the status quo in terms of investment strategy.

Pension fund trustee caution with respect to uncharted financial territory is not surprising, given the uncertainty surrounding fiduciary duty. However, the focus of pension fund trustees on fiduciary duty as the main reason for eschewing change in investment approach obscures significant behavioural impediments to sustainable investment: ingrained short-termism regarding both financial performance and environmental impact, and institutional inertia. These impediments, when combined with the prudence standard's constant reference to the status quo, create a collective action problem: in order for climate change to become an accepted consideration for pension fund trustees, a group of trustees must act in unison.

IV. Ingrained Inertia, Short-termism and Collective Inaction

Fiduciary duty is an oft-cited cause for resistance to innovation in investment culture, but it must not be mistaken for the only, or even most important one. While trustees' fears relating to fiduciary duty and environmental impact are understandable given conservative interpretation of the prudence standard in the past, the influence of fiduciary duty is overstated. This paper has argued that there is no inherent conflict between pension funds' fiduciary duty and the consideration of climate change as a risk or opportunity, in circumstances where climate change is likely to have a demonstrable financial impact over the long term. The inherent flexibility of fiduciary duty, although incremental, is such that it should be able to adapt to the demands of a climate change economy over time. Clarification by legislators could go a long way toward reducing the confusion-induced inaction on environmental issues attributed to fiduciary duty. In the meantime, the prominence of fiduciary duty as an explanation for stagnation in pension fund investment culture dissembles the more insidious reasons: the behavioural phenomena of institutional inertia and short-termism, which feed into a collective action problem.

This section argues that short-termism and inertia with respect to financial performance and environmental impact are central reasons for pension funds' slow reaction to change, and specifically, to climate change. While much has been said about how behavioural biases can affect financial performance, much less studied is how these biases can prevent innovation in the wider sense. In reality, these behavioural biases mean that the pension fund industry is slow to conduct self-examination, slow to diagnose its systematic short-comings, and slow to treat them. It is asserted here that strong leadership from within the pension fund industry is needed to combat these problems.

Initiating change is an enduring problem for institutions. This problem becomes all the more pertinent as today's increasingly complex financial, economic and environmental conditions require not only change, but urgent change, to the way that financial institutions operate. Studies in psychology and economics have shown that behavioural inertia exists at an individual level, and that this individual behaviour is carried into group decisions within institutions. As a result,

fiduciary duty's tendency to limit investment innovation is matched by resistance to change within the boards of pension funds. Pension fund trustees, this section argues, have a strong preference for the status quo when faced with decision-making. Moreover, pension fund trustees generally find it difficult to integrate unfamiliar variables, such as climate change, into their decisions about investment. These limitations to trustees' ability to innovate investment processes in the context of climate change need to be recognised: even when legislation clarifies the reach of fiduciary duty, pension funds themselves will need to address their tendency toward inertia in investment strategy development.

Individuals generally are resistant to behavioural change. William Samuelson and Richard Zeckhauser demonstrate that when making a decision, people are biased toward maintaining the status quo.¹⁸¹ They suggest that status quo bias exists largely because individuals want to avoid the cost of changing their behaviour, and because people tend to prefer the certainty of the status quo to the uncertainty of change. This behavioural trait may be linked to a second trait: loss averseness.¹⁸² People generally prefer accepting a lower, but more certain gain than taking a risk for a higher, but more uncertain gain.¹⁸³ Therefore the status quo is not only less costly, but also more certain.

This preference for the status quo has been demonstrated in the decision-making of pension fund trustees.¹⁸⁴ It is perhaps somewhat counterintuitive that pension fund trustees are subject to behavioural biases in their trust fund management capacity, given that in their role as trustees they are investing other peoples' money. However, Clark *et al* have shown that trustees are often even more careful with trust funds,¹⁸⁵ reflecting perhaps a desire to respect the parameters of fiduciary duty and a reverence toward the higher stakes involved, and their potential personal liability. Their study finds that 'trustees believe that their beneficiaries would not, all things being equal, assume any risk if they could avoid it.'¹⁸⁶ It should be noted that status quo bias also appears to affect beneficiaries when faced with similar decisions in defined contribution funds. In these funds, beneficiaries have some ability to direct the investment management of their own fund benefit. However, the majority of such beneficiaries in the US and UK retain the default plan, rather than opting for a tailored plan.¹⁸⁷ As a result, defined contribution funds are unlikely to differ much in practice from defined benefit funds when it comes to tackling the problem of climate change: since beneficiaries usually choose to leave decisions up to trustees, trustees voices still remain crucial to the investment strategy of most defined contribution funds.

The addition of novel contextual layers, such as the consideration of unfamiliar variables, to decision-making, may weaken the ability of pension fund trustees to make sound investment decisions. Clark *et al*'s 2007 study indicates that pension fund trustees, who are generally men in the 50s¹⁸⁸, while more competent than Oxford undergraduates 'when asked to solve a problem that

¹⁸¹ William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making* 1 J. RISK & UNCERTAINTY 7, 47-48 (1988).

¹⁸² Daniel Kahneman & Amos Tversky, *Prospect Theory: An analysis of decision under risk* 47 ECONOMETRICA 263, 284-89 (1979).

¹⁸³ *Id.*

¹⁸⁴ See Clark *et al.*, *supra* note 33; see also Gordon L. Clark, Emiko Caerlewy-Smith & John C. Marshall, *Pension Fund Trustee Competence: Decision making in problems relevant to investment practice*, 5 J. PENSION ECON. & FIN. 91 (2006).

¹⁸⁵ Clark *et al.*, *supra* note 184, at 101-2.

¹⁸⁶ *Id.* at 102.

¹⁸⁷ Alistair Byrne *et al.*, *Default Funds in UK Defined-Contribution Pension Plans*, 63 FIN. ANALYSTS J. 40, 40 (2007) (noting findings that from a survey of plans that 48-81 percent of US defined contribution plan assets and over 80 percent of such assets in the UK were invested in the default fund).

¹⁸⁸ See, Clark *et al.*, *supra* note 33, at 73.

drew upon specific knowledge derived from the context of their roles and responsibilities’,¹⁸⁹ are less competent at integrating new contextual layers into their decision-making than Oxford undergraduates. It was found that the inclusion of new ‘normative issues’ expanded decision-making requirements ‘well beyond trustees’ roles and responsibilities’.¹⁹⁰

The addition of the new considerations surrounding climate change tests pension fund trustee decision-making in just this way: it adds a novel contextual layer to decision-making. Because pension fund trustees prefer to avoid changing their current investment processes, the addition of a novel contextual element to the process makes it harder for pension fund trustees to make rational decisions. The context of climate change is likely to be difficult for pension fund trustees to accommodate under their current decision-making frameworks. Status quo bias is therefore a major challenge for pension funds adjusting to innovative investment strategies in a climate change economy.

It is worth noting that a higher degree of professional qualification in trustees appears to *increase*, rather than decrease, their aversion to innovation in investment strategies.¹⁹¹ This may indicate that professional training in trustees reinforces existing bias toward inertia within the industry.

The second behavioural bias restricting pension fund innovation in the context of climate change is institutional myopia, or short-termism. That humans discount the value of the future is well established in psychology and economics.¹⁹² What matters here is the extent to which this phenomenon also affects pension fund trustees in their capacity as fiduciaries: most institutional investors focus on short-term performance to such an extent that investee corporations act to promote short-term gains at the expense of long-term performance.¹⁹³

While pension funds usually have long time-horizons (to provide retirement income to current workers in the future), the Myners Report investigating short-termism in UK institutional investment found that the reward system of pension funds is structured to favour short-termism.¹⁹⁴ In particular, bonuses for asset managers are awarded on an annual basis, and investee company performance is monitored quarterly. Moreover, while short-term performance is easily measured, long-term value can only be predicted. The practical shortcomings in the methods available for measuring long-term performance are difficult to overcome. A potential solution for measuring long-term value is to assess the soundness of the investment *process* itself, rather than continuous reference to share price, but this method does not provide the quick and easy answer found in share price.

In this context, the tendency for fiduciary duty to encourage the maintenance of the status quo reinforces pension funds’ ingrained preference for short-term performance over long-term value. It does more than merely reinforce these preferences, however. It also provides a smokescreen behind which these behaviours may escape scrutiny. To the extent that pension fund trustees and asset managers attribute their inaction to fiduciary duty, the concept of fiduciary duty obscures a capacity for change which is not only real, but also, increasingly, necessary.

¹⁸⁹ *Id.* at 82.

¹⁹⁰ *Id.*

¹⁹¹ Emiko Caerlewy-Smith, Gordon L. Clark & John C. Marshall, Commentary, *Agitation, Resistance, and Reconciliation with Respect to Socially Responsible Investment: the attitudes of UK pension fund trustees and Oxford undergraduates* 38 ENV. & PLAN. A 1585, 1586 (2006).

¹⁹² See e.g., George Lowenstein & Richard Thaler, *Anomalies: Intertemporal Choice* J. 3 ECON. PERSPECTIVES 181 (1989).

¹⁹³ See e.g., Clark et al., *supra* note 184, at 97-99.

¹⁹⁴ PAUL MYNERS, INSTITUTIONAL INVESTMENT IN THE UNITED KINGDOM: A REVIEW (2001).

When combined with the tendency of the trustees and courts to judge prudence by reference to conventional behaviour, these behavioural biases (especially inertia), create a problem of collective action within the pension fund industry. As this paper has argued, courts, legislation and trustees themselves all refer to conventional behaviour in order to determine what prudent investing is. As short-term focused, narrowly construed strategies are conventional for pension funds, these are widely seen as prudent missions. Independently of this, pension funds prefer to behave in accordance with conventional investment culture, which emphasises short-term financial performance, because they have behavioural biases toward cultivating, and then maintaining, short-termism on the one hand, and toward maintaining the status quo (that, is not challenging convention) on the other. Under these conditions, a collective action problem arises to hinder investment innovation: the adoption by a small number of pension funds of a climate change conscious investment strategy will be seen as imprudent, because these innovative funds will be bucking convention in the minority. In order for change to occur, it will require the participation of a larger number of funds, or at least a number of respected, leading pension funds – in short, it will require a change of convention, so that courts and other funds will find climate change to be a prudent consideration.

This paper has argued that the uncertainty surrounding the requirements of fiduciary duty (and most relevantly here, the duty of prudence), could be alleviated through legislative clarification. However, legislative clarification would only go part of the way toward facilitating the adaptation of pension funds to a climate change economy. In order to overcome the behavioural biases that sustain short-termism and inertia, and fuel a collective action problem that nurtures an unhealthy dedication to convention, change needs to come from within the pension fund industry itself. The best way for funds to address these biases is to implement considered governance practices.¹⁹⁵ Pension funds that believe in the need to innovate investment strategies with respect to environmental and social issues, and climate change in particular, need to promote change through strong leadership.

V. Conclusion

Pension funds, with their staggering financial holdings, have the capacity to bring climate change to the forefront of business agendas. By including climate change risk and opportunity explicitly in their investment strategies, pension fund trustees stand not only to improve the long term financial performance of their funds, but also to contribute to a more sustainable economy. Furthermore, given their prominence as service providers in the vacuum created by the retreat of the state, it is arguable that pension funds have a *responsibility* to look beyond the financial impact of their decisions. However, very few pension funds have chosen to do so thus far. For most pension funds, climate change, like other issues trustees see as tangential to financial performance, remains beyond the scope of investment strategy.

Pension funds' reluctance to expand their investment strategies beyond their conventional barriers into the consideration of environmental issues is frequently attributed to trustees' fiduciary duty. For many years, trustees have interpreted this duty as preventing the consideration of non-financial issues in investment decision-making. Climate change, whose potential economic effects have only recently become widely accepted, is perceived as one of these. This paper has argued that this interpretation of fiduciary duty, based on outdated case law, is too narrow. Moreover, to the extent that climate change presents a real financial concern which is likely to increase as further legislation

¹⁹⁵ See Gordon L. Clark & Roger Urwin, *Best-Practice Pension Fund Governance*, 9 J. ASSET MGMT 12, (2008); see also Gordon L. Clark & Roger Urwin, *Making Pension Boards Work: the critical role of leadership*, 1 ROTMAN INT. J. OF PENSION MGMT 38, 40-44 (2008).

affects the price of carbon, pension funds' consideration of climate change in devising their investment strategy should not, *in theory*, conflict with even a narrow interpretation of fiduciary duty.

In practice, however, the lack of recent case law and unclear commentary on fiduciary duty has created uncertainty for pension funds wishing to adapt to a climate change economy. Pension funds' concerns about fiduciary duty are to an extent justified. Past legal analyses have supported the classification of environmental issues as 'non-financial' issues, which, together with ethical, political and social issues, should not influence a fiduciary's investment strategy. As it stands, fiduciary duty in both the US and the UK provides a reason for pension funds to delay changing their investment policies to accommodate the more complex investment approach demanded in a climate change economy. Although fiduciary duty has a proven ability to adapt to changing social circumstances, this adaptation is incremental, and ill-suited to the rapid changes required to meet the challenges of climate change. Clarification through legislation would help to alleviate the uncertainty surrounding fiduciary duty.

The advent of the financial crisis has given us a moment of pause to examine the state of finance and what it represents. For the work presented here, it represents both an end and a beginning. First, an end: the financial crisis heralds the demise of the efficient markets hypothesis. With its end, the colourful realities of human behaviour are suddenly more apparent against the hitherto black and white background of economic theory. These realities of human behaviour, in particular biases of inertia and myopia, are the greatest barrier to the pension fund industry's shift toward more sustainable investment strategies. The truth is, this paper has argued, fiduciary duty is only part of the problem. An unclear notion of fiduciary duty feeds into these biases, making them crippling. When these biases combine with prevailing pension fund view that prudence equates to conventional behaviour, a collective action problem results: pension funds are unlikely to break with convention unless a significant number of them change their approach simultaneously. Any institutional acceptance of innovation toward a longer term, more sustainable investment strategy will take strong leadership from pension funds themselves. It is fortunate then that the financial crisis also represents a beginning: it provides an opportunity for re-evaluation, and a chance to improve the sustainability of the financial system.

The implications to be drawn from this paper are threefold. First, the uncertainty surrounding pension fund fiduciary duty and environmental considerations, in particular climate change, should be clarified through legislation. Without this clarification, pension fund trustees will have all the impetus they need to shy away from changes they were already reluctant to make. Second, pension funds must re-examine their approach to investment, as they once did at the advent of modern portfolio theory – any move toward a more sustainable investment approach will require funds to act on their own behalf. An adoption of best practice governance measures will help pension funds to surmount the behavioural barriers to innovation. Finally, a broader point: this paper has allowed a brief, and rather dismal, glimpse at how Anglo-American courts interact with the institutional investment industry – in short, they appear to reinforce the industry's existing behavioural problems and mutual uncertainties about the application of fiduciary duty in an investment context. In this light, the spectre of fiduciary duty becomes a means to ensure that existing financial norms, of the sort that fuelled the present financial crisis, remain untouched.