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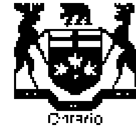

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Investment Responsibility: Prudence in Action

The *Pension Benefits Act*, 1987 (the "PBA") replaced the "legal for life" approach to pension fund investment with the concept of prudence. The relevant subsections are 23(1), (2), (3), (5), (7) and (8) and 63(1) of the PBA, 1987 and subsection 63(2) of the Regulation.

The current pension legislation also deals with conflicts of interest, which was discussed in the last issue of the PCO bulletin. Conflicts of interest, the concept of prudence and the delegation of investment responsibility are three elements of a standard of care imposed on Administrators and their agents by the PBA, 1987.

How did we get here?

Subsection 23(1) is commonly called the "prudent person" rule; its origin goes back several hundred years in the law of trusts. The classic statement was made in Britain in 1886: "The duty of a trustee is not to take such care only as a prudent man would take if he had only himself to consider, the duty rather is to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide." [i] This standard has been applied by Canadian courts, albeit to investments made by a trustee from the statutory list of securities or from securities authorized.

It is interesting to compare this standard with the prudent man rule in effect in the United States, because Canadian investment managers have thought predominantly in terms of North American context. Justice Putnam of Massachusetts laid down this rule about 160 years ago: "All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of the capital to be invested." [ii]

The essential difference is that the model statute in the United States sets up as the standard of care the judgement that

a prudent person exercises in the management of his or her own affairs, whereas under the standard applied by the courts in Canada, emphasis is put on the management of other people's money. The Canadian courts thus impose a higher standard of conduct than the rule in the United States.

However, Canadian investment managers have been relieved that there was no counterpart to another United States law, the *Employee Retirement Income Security Act* ("ERISA"). As it was originally applied, every investment has to be prudent per se. This interpretation was the traditional one dating from 1830 whereby only "investment" was allowed and "speculation" was not, and led to the drafting of "legal lists" and the labelling of particular investments as speculative for all time and purposes.

As modern portfolio theory was formulated and its principles of portfolio management became widely accepted, there arose a conflict with these constraining notions of prudence. Fortunately, the law of prudence has evolved in conjunction with investment theory and the realities of the marketplace. ERISA and its Regulation now do not prescribe the specific investments pension funds may make. Instead, it imposes on Administrators a general duty to act prudently, "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..." [iii] Another requirement is to "diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." [iv]

We can see that the emphasis has moved to the decision-making process in judging investment prudence. As the United States Department of Labor has stated: "(1) Generally, the relative riskiness of a specific investment does not render such investment either per se prudent or per se imprudent, and (2) the prudence of an investment decision should not be judged without regard to the role that the proposed investment...plays within the overall plan portfolio." [v]

The closing of the gap between the old prudent person rule and the modern standard of care was reconfirmed as recently as 1988 by a United Kingdom court decision in which the judge referred to the 1886 statement quoted above as follows: "This is an extremely flexible standard capable of adaptation to current economic conditions and contemporary understanding of markets and investments. For example, investments which were imprudent in the days of the gold standard may be sound and sensible in times of high inflation. Modern trustees acting within their investment powers are entitled to be judged by the standards of current portfolio theory, which emphasizes the risk level of the entire portfolio rather than the risk attaching to each investment taken in isolation. (This is not to say that losses on investments made in breach of trust may be justified when held in conjunction with other investments.) But in reviewing the conduct of trustees over a (long period of time), one must be careful not to endow the prudent trustee with prophetic vision or expect him to have ignored the received wisdom of his time." [vi]

By what standard is prudence measured?

The focus has shifted from each particular investment to the Administrator and his agents, the portfolio, and the investment objectives as set out in the Statement of Investment Policies and Goals (SIP&G). To quote from Bevis Longstreth, a former Securities and Exchange Commission commissioner and author on the subject, "Prudence is a test of conduct not performance,...(a) paradigm of prudence (is) based above all on process. Neither the overall performance of the portfolio nor the performance of the individual investment should be viewed as central to the (prudence issue). Prudence should be measured principally by the process through which investment strategies and tactics are developed, adopted, implemented, and monitored. Prudence is demonstrated by the process through which risk is managed rather than by the labelling of specific investments as either prudent or imprudent. Investment products and techniques are essentially neutral; none should be classified prudent or imprudent per se. It is the way in which they are used, and how decisions as to their use are made, that should be examined to determine whether the prudence standard has been met....Prudence is not self-evident. Nor will it be enough to point to their use by other fiduciaries. What matters is not that others have used the product or technique (for whatever reasons), but the basis for its use by the fiduciary in question." [vii]

Although this formulation of prudence has been made in the context of United States trust law, it is clearly applicable in complying with the PBA, 1987. An object of the new Ontario rules is to authorize pension funds to use modern portfolio management techniques and tools, and to modernize and liberalize the concept of prudence. This shows up in subsection 63(2) of the Regulation, quoted at the end of this article, whose purpose is to have an investment selection made with consideration given to the overall context of the portfolio, keeping in mind that the selections match the objectives established for the portfolio in the SIP&G.

Despite the replacement of the "legal for life" approach to investment, and the removal of quality tests and the "basket clause", the Regulation has retained certain specific limits pertaining to diversification, control of individual companies, and conflicts of interest. The mere compliance with these limits will not be considered evidence of the minimum standard of prudence. Notwithstanding these limits, all investments have to be made in accordance with the stipulations of the PBA, 1987, the Regulation, and the SIP&G. As stated above, it is the process followed in making the investments that will be examined to monitor the standard of care applied to the process.

Finally, subsection 23(2) of the PBA, 1987 stipulates that an Administrator must apply all the relevant knowledge and skill that he or she possesses or ought to possess by reason of his or her profession, business or calling. It is therefore incumbent on Administrators and their agents, especially investment managers, to keep abreast of developments in investment theory, practices and tools, and to make a conscious study of whether their use are applicable to the achievement of the investment policies that ought to be adopted by a pension fund given the nature of the plan and its liabilities.

Footnotes

(i) L.J. Lindley, Re Whiteley (1886) 33 Ch D 347,355
(ii) Justice Putnam Harvard College c. Amory, Supreme Judicial Court of Massachusetts, 9 Pickering 446 (1830)
(iii) Employee Retirement Income Security Act of 1974 as amended through 1984, Section 404 (a)(1)(B)
(iv) Idem, Sec. 404 (a)(1)(C)
(v) U.S. Department of Labor, 44 Federal Regulations 37,221 and 37,222, June 26, 1979
(vi) Justice J. Hoffman, Nestle v. National Westminster Bank PLC, unreported decision of the Chancery Division of the High Court, U.K., dated June 29, 1988
(vii) Bevis Longstreth, Modern Investment Management and the Prudent Man Rule (1986, Oxford University Press, New York).

*PBA, R.S.O. 1990 s. 22 and s. 62