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Fiduciary Society Unleashed: The Road Ahead for the Financial Sector

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Fiduciary Society Unleashed: The Road Ahead for the Financial Sector

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Edward J. Waitzer & Douglas Sarro

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Keywords:

Fiduciary, Financial Sector Reform, Governance, Intergenerational Equity, Institutional Investors, Pension Funds, Prudent Person Standard

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By Edward J. Waitzer* and Douglas Sarro**

Informational asymmetries, misaligned incentives, and artificially elongated chains of intermediation have created a disconnect between the financial sector and the “real economy” that is detrimental to the public interest. Courts and regulators are increasingly intervening to break the cycle. We argue that fiduciary law offers a conceptual framework both for understanding and responding to this trend, and that the financial sector, rather than waiting for this trend to develop and reacting to new rules in a piecemeal way, should be proactive and try to shape the way in which this trend develops. We describe some elements of what such an approach might look like, and consider how regulators and political institutions can encourage financial institutions to adopt this approach, and in so doing support a broader transition to a more sustainable economy.

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INTRODUCTION

Society faces increasingly complex governance challenges. While there is a growing recognition that we need to take and act on a longer-term view, the incentives for myopic leadership and action remain acute. There is much aspirational talk about social responsibility, social reporting, long-termism, and the like, but implementation is nascent and sporadic. While temporal discounting has long been known to matter in making individual choices, its nature and utility in collective decision making remains poorly understood. Likewise, our ability to control activities with negative externalities has been limited by uncertainty with respect to future costs and, more importantly, a lack of incentives to price and allocate such costs equitably.

There is little question as to the trajectory of the law. By choice, by chance, or by default, it is increasingly responding to diminished public trust in major institutions by imposing a standard of “reasonable expectations.”¹ To the extent that legislators are unable or unwilling to do so, our courts and adjudicative tribunals have demonstrated a willingness to step in.

A case in point is with respect to the regulation of corporate conduct. Corporate law is premised on the notion of limited liability conferred by statute—to facilitate the mobilization of capital, shareholders are not held personally responsible for a corporation’s liabilities. Over the past year, however, a series of decisions by various courts and regulatory bodies has responded to “reasonable expectations” by circumscribing the scope of limited liability, holding parent corporations responsible for the liabilities and misconduct of their subsidiaries.² In these cases, the public interest in discouraging excessive risk-taking and other harmful conduct was found to outweigh the benefits of protecting shareholders from liability.

This article focuses on similar trends in the financial sector. The sector stands out for scrutiny for a variety of reasons. For one, it continues to enjoy significant public subsidies without a clear and current articulation of its social purpose and responsibility.³ It may also be unique as a supply chain in which agents typically

1. See *BCE Inc. v. 1976 Debentureholders*, 2008 SCC 69, [2008] 3 S.C.R. 560 (Can.).

2. See, e.g., *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129 (1st Cir. 2013) (private equity company held liable for unfunded pension liabilities of one of its portfolio companies under ERISA); *Pension Benefit Guar. Corp. v. Asahi Tec Corp.*, No. 10-1936 (ABJ), 2013 WL 5503191 (D.D.C. Oct. 4, 2013) (Japanese corporation held liable for unfunded pension liabilities of its U.S. subsidiary under ERISA); *Choc v. Hudbay Minerals Inc.*, 2013 ONSC 1414, 116 O.R. (3d) 674 (Ont. Super. Ct. J.) (Ontario Superior Court of Justice refuses to strike a claim against a Canadian mining corporation for human rights abuses alleged to have been carried out by its subsidiary in Guatemala); *Alcoa Inc.*, Exchange Act Release No. 71261, 2014 WL 69457 (Jan. 9, 2014) (international aluminum producer charged under Foreign Corrupt Practices Act for bribery carried out by its subsidiaries in Bahrain; agrees to pay \$384 million in fine). For a general discussion of some of the negative consequences of limited liability, see Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 *YALE L.J.* 1879 (1980).

3. See ANDREW ROSS SORKIN, *TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES* (2010). According to one recent study, for the ten largest U.S. banks, “too big to fail” status means benefits equivalent to an \$83 billion annual subsidy from taxpayers. See Editorial, *Why Should Taxpayers Give Big Banks \$83 Billion a Year*, *BLOOMBERG VIEW* (Feb. 20, 2013, 6:30 PM EST), <http://goo.gl/E3Gbjc>.

fare better than principals. In most other sectors, complexity has been harnessed to benefit customers. In contrast, there is now widespread agreement that increasing complexity in financial flows, instruments, and regulation has exacerbated informational asymmetries, eroded institutional cultures, and confounded traditional regulatory frameworks—often to the detriment of consumers.⁴ For example, while technological advances have radically reduced costs in other trade sectors, the costs of financial intermediation have increased since the mid-1970s and are higher now than they were at the turn of the twentieth century.⁵ Financial services lag other sectors by a generation in developing common data standards.⁶

It should therefore come as no surprise that the financial sector attracts low confidence—both within and without. For example, a recent survey of 250 U.S. financial services professionals revealed that most believe their competitors engage in illegal or unethical activity in order to be successful.⁷ Moreover, notwithstanding the proliferation of “ethics” courses in most MBA curricula, the problem is most acute amongst younger employees.⁸ Likewise, a recent survey by the conservative American Enterprise Institute found a persistent lack of trust in Wall Street five years after the financial crisis, suggesting deep public misgivings about the operations of the financial sector.⁹ The consensus is that many firms are not ethical or are not concerned about the well-being of the economy.

Without assigning blame, part of the story of the global financial crisis was rooted in the bias to retrospection amongst regulators, policy makers, and academics—focusing on near-term data and clinging to the notion that markets were perfectly efficient, despite a wealth of evidence to the contrary.¹⁰ Any system built on a mismatch between expectations and actual outcomes is inevitably

4. See Henry T. C. Hu, *Too Complex to Depict Innovation, “Pure Information,” and the SEC Disclosure Paradigm*, 90 TEX. L. REV. 1601 (2012); Sunita Sah, George Lowenstein & Daylian M. Cain, *The Burden of Disclosure: Increased Compliance with Distrusted Advice*, 104 J. PERSONALITY & SOC. PSYCH. 289 (2013); Andrew G. Haldane & Vasileios Madouros, Speech at the Federal Reserve Bank of Kansas City’s 36th Economic Policy Symposium: The Dog and the Frisbee (Aug. 31, 2012), available at <http://goo.gl/Mbn9mo>; Luigi Zingales, Opinion, *Why I Was Won Over by Glass-Steagall*, FIN. TIMES, June 11, 2012, at 11.

5. Thomas Philippon, *Finance Versus Wal-Mart: Why Are Financial Services So Expensive?*, in RE-THINKING THE FINANCIAL CRISIS 235, 239 (Alan S. Blinder, Robert M. Solow & Andrew W. Loh eds., 2012).

6. Robleh D. Ali, Andrew G. Haldane & Paul Nahai-Williamson, Speech at the Securities Industry and Financial Markets Association Symposium on Building a Global Legal Entity Identifier Framework: Towards a Common Financial Language 2 (Mar. 14, 2012), available at <http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech552.pdf> (“Today’s financial chains mimic product supply chains of the 1980s and the information chains of the 1990s.”).

7. LABATON SUCHAROW LLP, WALL STREET IN CRISIS: A PERFECT STORM LOOMING—LABATON SUCHAROW’S U.S. FINANCIAL SERVICES INDUSTRY SURVEY 3 (July 2013), available at <http://www.secwhistlebloweradvocate.com/LiteratureRetrieve.aspx?ID=182189>.

8. *Id.* at 5 (38 percent of survey respondents with less than ten years’ experience said they would insider trade if they could get away with it).

9. See KARLYN BOWMAN & ANDREW RUGG, FIVE YEARS AFTER THE CRASH: WHAT AMERICANS THINK ABOUT WALL STREET, BANKS, BUSINESS, AND FREE ENTERPRISE (2013), available at <http://goo.gl/LACZdq>.

10. See JOHN KAY, THE KAY REVIEW OF UK EQUITY MARKETS AND LONG-TERM DECISION MAKING: FINAL REPORT ¶¶ 4.1–4.19 (2012); see also Sanford J. Grossman & Joseph Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393 (1980).

going to be prone to crisis. Arguably, notwithstanding reams of additional regulation, that risk is as acute today as it was a decade ago. The view that another financial crisis is inevitable and imminent casts a long shadow.¹¹

Rules, institutions, and cultures that reward those who take advantage of informational asymmetries or succumb to a self-destructive cycle of short-termism have generated unhealthy outcomes for the system. Financial services are critical to ensuring future well-being. We need a financial system that reflects the diversity of human motives and allows people to enter into complex and incentivizing transactions to further their goals—a system that channels the human impulse toward competition and conflict into a manageable arena that is both peaceful and constructive.¹² To do so, the financial services sector must have broad regard for the systemic effects of its actions. It must focus on how investment can create better markets tomorrow, rather than simply “beating” the market today.

We argue that our courts and regulators are looking for opportunities to better define and protect the public interest. This trend is likely to lead to the imposition of public stewardship responsibilities throughout the financial services supply chain. We argue that the financial services sector, rather than waiting for this trend to develop and reacting to new rules in a piecemeal fashion, should be proactive and try to shape the way in which this trend develops.

We will develop this argument as follows. First, we provide a number of recent reference points, designed to illustrate the trajectory of the law and the increasing velocity and intensity of regulatory reform. We then review the dynamic evolution of fiduciary standards in the financial services sector—which, we suggest, provides a conceptual and normative context for much of these reform initiatives. We conclude by outlining likely areas for financial sector reform and suggesting ways the sector itself (and those who rely on it for the efficient mobilization and allocation of capital) might proactively shape the trajectory of the law.

A PENDING INFLECTION POINT

It is difficult to read the business section of any major newspaper without finding at least one article pointing to how the financial services sector has become disconnected from the needs of the “real economy.” Before considering how a dynamic re-framing of fiduciary obligations is likely to motivate a re-imagining of the social utility of financial services, it may be helpful to highlight a few recent examples of dysfunction, and consequential regulatory responses, which suggest the likelihood that we have reached an inflection point. In none of these examples are the highest echelons of the institutions under scrutiny clearly implicated in any wrongdoing. In some examples, the behavior these institutions engaged in may not even have been technically illegal. What went wrong, rather, was that these institutions focused on *doing things right*—i.e., in technical compliance with whatever legal rules existed at the time—rather than *doing the right thing*.

11. Over half of the CFA Institute members predict a financial bubble in their home markets in the coming year. See CFA INST., GLOBAL MARKET SENTIMENT SURVEY 142 (2014).

12. See ROBERT J. SHILLER, FINANCE AND THE GOOD SOCIETY 228–29 (2012).

They engaged in conduct that was legal but unfair to market participants, or they instituted compliance controls that may have appeared adequate in light of what peer firms were doing but that ultimately failed to prevent improper activity by employees. We argue that regulatory reactions to this conduct—increasingly punitive sanctions, justified on the basis of market fairness—should lead institutions to rethink their assumptions about the public purpose of the financial sector and how best to respond to rising public expectations.

As this article is being written, regulators in several jurisdictions are investigating alleged manipulation of the \$5.3 trillion-a-day foreign exchange market.¹³ The allegations involve collusion among traders to fix benchmark exchange rates in their favor, resulting in higher costs for consumers (including pension funds, mutual funds, and multinational corporations that routinely trade in exchange rates). In a market this large, even a scheme that skims fractional amounts translates into billions of dollars. Since traders' bonuses are based on trading profits, they have ample reason to collude and manipulate, especially in the absence of transparent markets or strong oversight. Remarkably, in 2012 the Obama administration added to the opacity of foreign exchange markets when it exempted certain foreign exchange derivatives from the application of new rules under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").¹⁴

Significant fines and penalties are likely inevitable, given regulators' responses to other recently uncovered misconduct. For instance, since 2009, the seven largest U.S. banks have paid out or set aside more than \$45 billion for mortgage misrepresentation issues (and incurred roughly \$5 billion in combined legal expenses).¹⁵ Standard & Poor's estimates that these banks may need to pay out an additional \$55–\$105 billion to settle mortgage-related issues.¹⁶ In 2013 alone, JPMorgan paid out regulatory penalties of \$20 billion on matters ranging from mortgage misrepresentations to failing to report Bernard Madoff's suspicious activities to the authorities.¹⁷ Many believe the institution, and others like it, have become so large and complex that it may be impossible to keep employees in line—"there is too much of an incentive for an individual to cut corners."¹⁸

The Credit Card Accountability Responsibility and Disclosure Act of 2009 (the "Card Act")¹⁹ is an example of legislative efforts to remedy conduct that, while not illegal, was perceived as being unfair to consumers. The Card Act was enacted in response to a perception that banks were gaming consumers on fees for late payments or for borrowing more than their credit limit (e.g., by raising

13. Editorial, *Another Banking Scandal*, N.Y. TIMES, Nov. 21, 2013, at A28.

14. Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69694 (Nov. 20, 2012).

15. *The Largest U.S. Banks Should Be Able to Withstand The Ramifications of Legal Issues*, STANDARD & POOR'S RATING SERVICES, 2 (Nov. 25, 2013), available at <http://goo.gl/IG8vvr>.

16. *Id.*

17. Peter Eavis, *Steep Penalties Taken in Stride by JPMorgan*, N.Y. TIMES, Jan. 8, 2014, at A1.

18. *Id.* (quoting Paul Miller, bank analyst at FBR Capital Markets).

19. Pub. L. No. 111-24, 123 Stat. 1734 (codified in scattered sections of 15 U.S.C.).

these fees without notice and without giving reasons).²⁰ It imposes a series of restrictions on banks' behavior: among other things, it imposes limits on the number and types of charges banks can impose and requires banks to give customers twenty-one days' notice of monthly bills and forty-five days' notice of any increase in interest rates.²¹ The Card Act has proven effective—a recent study found that, on average, the new law saved consumers an annualized 1.7 percent of the average daily balance on their cards—a staggering \$12.6 billion per year.²²

High-frequency trading, particularly the early release of market information to high-frequency traders, is another area where we can expect new rules to emerge. In July 2013, Thomson Reuters suspended the practice of selling market-moving data (a consumer confidence index) to high-frequency algorithmic traders up to two seconds ahead of making it available to other subscribers. This was in response to an investigation launched by the New York State Attorney General's office which, apparently, took up the matter after a whistleblower complaint had been filed with the U.S. Securities and Exchange Commission.²³ There was no allegation of conventional illegality. Indeed, Thomson Reuters insisted that it had the right to "legally distribute non-governmental data" to "fee-paying subscribers."²⁴

Illustrating the potential value of "latency" (i.e., the time it takes for a stock quote to get from an exchange's server to a trader's screen) in high-frequency trading, one study estimated that a high-frequency trader could theoretically generate just over \$32,000 by trading for one day in Apple stock, simply by picking off quotes on various exchanges that were fractions of a second out of date.²⁵ Extrapolating that number to reflect the thousands of stocks trading electronically suggests that billions of dollars are being skimmed from the market.²⁶ Stock exchanges not only encourage, but profit from, this activity. Many exchanges are "landlords"—allowing high-frequency traders to place their trading computers near the exchange's servers to access prices a few milliseconds ahead of other traders (a service called "co-location"). What is more, regulation may have contributed to the problem—Regulation NMS, which requires brokers to execute trades

20. See Floyd Norris, *Card Act Cleared Up Credit Cards' Hidden Costs*, N.Y. TIMES, Nov. 7, 2013, at B1.

21. See 15 U.S.C. §§ 1666(a), 1637(o)(1), 1637(i)(1), 1693(a), 1637(j)–(l) (2012).

22. Sumit Agarwal, Souphala Chomsisengphet, Neale Mahoney & Johannes Stroebel, *Regulating Consumer Financial Products: Evidence from Credit Cards 3* (Apr. 2014) (unpublished manuscript available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2330942).

23. Matt Taibbi, *Sixteen Major Firms May Have Received Early Data from Thomson Reuters*, ROLLING STONE POL. (Sept. 5, 2013, 2:25 PM EST), <http://goo.gl/xhGL64>.

24. *Id.* More recently, Berkshire Hathaway's Business Wire reported that Berkshire Hathaway has decided to stop giving high-speed traders direct access to news releases, after consultations with the New York Attorney General's office. See Scott Patterson, *Traders' Access to Releases Curbed*, WALL ST. J., Feb. 21, 2014, at C1.

25. Shengwei Ding, John Hanna & Terrence Hendershott, *How Slow Is the NBBO? A Comparison with Direct Exchange Feeds*, 49 FIN. REV. 313, 323 (2014).

26. See Eric T. Schneiderman, *Address at New York Law School: High-Frequency Trading & Insider Trading 2.0*, at 5 (Mar. 18, 2014), available at http://www.ag.ny.gov/pdfs/HFT_and_market_structure.pdf.

at the “best price available,” has been widely blamed for helping spur an “arms race” on the part of traders to get prices and other information faster.²⁷

Recent settlements reached between prosecutors and major financial institutions show that the early release of market-moving information is not a problem limited to the high-frequency trading arena. A few months after the Thomson Reuters issue surfaced, Citigroup announced it was paying a \$30 million fine to Massachusetts to settle charges that one of its analysts offered unpublished research related to orders for Apple iPhones to selected clients. Citigroup also agreed to undertake a three-year review of its policies and procedures. The fine came nearly a year after Citigroup paid Massachusetts \$2 million to settle charges that two other analysts shared non-public information about Facebook.²⁸

Like Thomson Reuters, BlackRock, the world’s largest asset management company, recently entered into a settlement with the New York Attorney General. It agreed to end its practice of surveying Wall Street analysts to glean advance information prior to public dissemination of their research reports. Attorney General Eric T. Schneiderman called BlackRock’s decision to end this practice “a major step forward in restoring fairness in our financial markets and ensuring a level playing field for all investors.”²⁹

British regulators recently called attention to unethical conduct by auditors and pension trustees. In September 2013, the U.K. Financial Reporting Council invoked new sanction powers to issue a “severe reprimand” and a £14 million fine against Deloitte for “placing their own interests ahead of the public” and compromising their own objectivity “in flagrant disregard of the professional standards expected and required.”³⁰ While the ethics rules of the U.K. professional accounting body require accountants to consider the public interest, the traditional view was that this only applied in respect of audit mandates.³¹ The tribunal, however, concluded that this duty applied to “all assignments and appointments” undertaken by an audit firm.³²

27. The regulation is now under review by the SEC. See Jacob Bunge, *A Suspect Emerges in Stock-Trade Hiccups: Regulation NMS*, WALL ST. J., Jan. 28, 2014, at A1; Steven M. Davidoff, *S.E.C.’s Review of Trading Will See Some of Its Own Work*, N.Y. TIMES, Feb. 12, 2014, at B5.

28. Alexandra Stevenson & Ben Protess, *SAC’s Forceful Ways Shown in Massachusetts Citi Case*, N.Y. TIMES, Oct. 4, 2013, at B1.

29. Press Release, N.Y. State Office of the Attorney Gen., New York State Attorney General A.G. Schneiderman Announces Agreement with BlackRock to End Its Analyst Survey Program Worldwide (Jan. 9, 2014), available at <http://goo.gl/FBR7oI>; see also Gretchen Morgenson, *BlackRock Agrees to Stop Pursuing Nonpublic Views*, N.Y. TIMES, Jan. 9, 2014, at B1.

30. Deloitte & Touche LLP, Report of the Tribunal ¶¶ 200, 270 (F.R.C. Sept. 9, 2013) [hereinafter Financial Reporting Council Tribunal Report], available at <http://goo.gl/SDjTLM>. The case arose out of corporate finance advice provided by Deloitte on the sale of MG Rover. The Financial Reporting Council found that Deloitte had failed to manage conflicts of interest arising from the dual role it took on as auditor to MG Rover and advisor to a group of directors who sought to buy the company. The directors succeeded in buying the company in 2000, but the company collapsed in 2005.

31. See INST. OF CHARTERED ACCOUNTANTS IN ENG. AND WALES CODE OF ETHICS ¶¶ 1.2, 100.1 (as amended Jan. 1, 2013); *Unintended Consequences of MG Rover*, ECONOMIA (Sept. 13, 2013), <http://economia.icaew.com/opinion/september-2013/unintended-consequences-of-mg>.

32. Financial Reporting Council Tribunal Report, *supra* note 30, ¶ 42.

In the same month, the U.K. Office of Fair Trading raised concerns about a number of older defined contribution pension plans, in which as many as 190,000 savers were thought to be paying 1 percent or more in annual charges (as opposed to the “new wave” of defined contribution plans, where charges tend to be half that amount).³³ The life-cycle effect of a 1 percent annual charge can reduce retirement savings by approximately 21 percent.³⁴ The study estimated that approximately £30 billion is tied up in these old plans.³⁵ The study also highlighted the lack of trustee competence and poor governance in 3,000 smaller pension schemes worth about £10 billion.³⁶ In response to the study, the Association of British Insurers (the “ABI”) agreed to conduct an audit of the older plans.³⁷ The ABI has also launched a public review of retirement income needs and the manner and extent to which the current system meets them.³⁸

It would not be surprising if regulators soon begin focusing their attention on the quality of the advice investment consultants give in exchange for the fees they charge. A recent study by three professors at Oxford University’s Saïd Business School found no evidence that the recommendations of investment consultants for U.S. equities helped investors to outperform their benchmarks or generate alpha (excess risk adjusted returns).³⁹ Rather, on average, products recommended by consultants underperformed non-recommended products by about 1 percent per year.⁴⁰ Leaving aside the fees paid to such consultants (in 2012, CalPERS paid \$33 million in such fees), such underperformance represents billions of dollars of lost value to current and future pensioners.⁴¹

While the foregoing discussion addresses action taken (or likely to be taken) by a wide range of regulators addressing diverse areas of the financial sector, the problems identified share common characteristics. First, in many instances those involved focused on compliance with rules rather than principles. There was no prohibition on Thomson Reuters selling advance access to market-moving data, nor is it illegal for high-frequency traders to generate returns through latency arbitrage. There is no rule that would prohibit the high fees identified in the Office of Fair Trading report or on charging for investment advice that ultimately fails to generate returns for clients. Deloitte did not believe it was under a duty to serve the public interest when it was acting outside of its capacity as an auditor. Though the institutions implicated in the mortgage misrepresentation and foreign

33. Josephine Cumbo, *OFT Stops Short of a Fees Cap*, FIN. TIMES, Sept. 21, 2013, at 3; OFFICE OF FAIR TRADING, DEFINED CONTRIBUTION WORKPLACE PENSION MARKET STUDY ¶¶ 6.42–6.51, 9.58 (2013) [hereinafter OFFICE OF FAIR TRADING STUDY], available at <http://goo.gl/Y6JfsD>.

34. OFFICE OF FAIR TRADING STUDY, *supra* note 33, ¶ 6.1.

35. *Id.* ¶¶ 6.1, 6.42.

36. *Id.* ¶ 9.25.

37. *Id.* ¶ 9.22.

38. See ASS’N OF BRITISH INSURERS, A NEW RETIREMENT—CALL FOR EVIDENCE (NOV. 18, 2013), available at <https://www.abi.org.uk/Insurance-and-savings/Topics-and-issues/A-new-retirement/Call-for-evidence>.

39. See Howard Johns, Tim Jenkinson & Jose Vicenti Martinez, *Picking Winners? Investment Consultants’ Recommendations of Fund Managers* (June 13, 2014) (unpublished manuscript available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2327042).

40. *Id.* at 6.

41. Andrew Ross Sorkin, *Doubts Raised on Advice Pensions Get*, N.Y. TIMES, Oct. 1, 2013, at B1.

exchange market manipulation scandals almost certainly had formal compliance controls in place, they plainly did not do enough to ensure that these controls worked in practice. By apparently aiming only to do enough to avoid a technical violation of the law as they understood it to be at the time, rather than fully considering the long-term consequences their actions could have for themselves and third parties, these institutions invited scrutiny and penalties from regulators.

Second, in many of these cases it is arguable that regulation contributed to the problem. By focusing on enforcement over prevention, increased regulation has tended to push financial institutions into a defensive posture—thinking about how to defend themselves in court rather than how to do the right thing. It has also fostered increased gaming by market participants, as the case of Regulation NMS illustrates. Other rules, discussed in the next part of this article, have encouraged investors to engage in herding into particular investments, leading to dangerous levels of risk in the financial system.⁴² These are examples of how market and regulatory imperfections can interact in powerful and often destructive ways. As Robert Shiller astutely observes, “[d]esigning financial institutions around the imperfections of regulators—as much as that can be done—is as important as designing financial institutions around the imperfections of market participants.”⁴³

It is clear that “doing it right” is no longer enough. Regulators, courts, and legislators that find examples of conduct that is not in line with “reasonable expectations” or that appears to be unfair will intervene, often with punitive sanctions. The question is whether there is a way of understanding this pattern, predicting its future course, and prescribing conduct that avoids further sanctions.

The next parts of this article argue that fiduciary law offers an answer to this question. It discusses the purpose fiduciary law is intended to serve, along with the way in which this area of the law has developed in respect of financial services. It argues that interventions by courts, regulators, and legislators can be understood as attempts to give life to a broad conception of fiduciary duty that recognizes the social function that financial services serve.

FIDUCIARY SOCIETY: EVOLVING STANDARDS IN THE FINANCIAL SECTOR

The body of human knowledge and understanding continues to grow exponentially. We are overwhelmed by information. No individual is capable of processing all of this information alone, let alone using it to make intelligent decisions in everyday life. By necessity, individual knowledge and expertise have become more specialized. As a result, we rely on specialists—in finance, medicine, law, financial services, and other disciplines—to help us take advantage of advances in human understanding. This combination of specialization and interdependence is essential to human progress. It fosters both the development of new

42. See *infra* notes 61–63 and accompanying text.

43. SHILLER, *supra* note 12, at 184–85.

knowledge and the use of this knowledge to help us make better decisions and achieve better outcomes.⁴⁴

But this combination is not sufficient. The traditional tools for supervising counterparties, available through the law of contract, cannot guarantee the effective delivery of specialized services. Individuals simply do not have the resources or the expertise to determine on their own whether these specialized services are actually serving their interests. Instead, these individuals need to *trust* that the specialists they rely upon will keep their best interests at heart.⁴⁵

Fiduciary law aims to promote this trust.⁴⁶ It applies to relationships in which one party, the *fiduciary*, gains discretionary power over another party, the *beneficiary*, in circumstances where both parties would “reasonably expect” that the fiduciary will exercise this power in the best interests of the beneficiary.⁴⁷ It imposes a standard of conduct higher than that normally found in the marketplace. It subjects the fiduciary to well-established duties of loyalty, obedience, and care.⁴⁸ In combination, they oblige the fiduciary to act prudently in the best interests of the beneficiary.⁴⁹

These duties are not a rigid code that can be addressed through “check box” compliance. Rather, they are open-ended and contextual, prescribing broad principles whose content can vary depending on the circumstances and that

44. See Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 802–03 (1983) [hereinafter Frankel, *Fiduciary Law*]; see also Alison G. Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738, 739–40, 747, 794 (1977); Tamar Frankel, *Fiduciary Law in the Twenty-First Century*, 91 B.U. L. REV. 1289, 1292 (2011); James E. Post, *Governance, Accountability, and Trust: A Comment on the Work of Tamar Frankel*, 91 B.U. L. REV. 1165, 1173 (2011); Ernest J. Weinrib, *The Fiduciary Obligation*, 25 U. TORONTO L.J. 1, 11 (1976).

45. See Frankel, *Fiduciary Law*, *supra* note 44, at 800, 803, 810, 812–14.

46. See Robert Flannigan, *The Fiduciary Obligation*, 9 OXFORD J. LEGAL STUD. 285, 310 (1989); Lawrence E. Mitchell, *The Naked Emperor: A Corporate Lawyer Looks at RUPA's Fiduciary Provisions*, 54 WASH. & LEE L. REV. 465, 480 (1997).

47. Historically, fiduciary duties only applied to lawyers, partners, corporate directors, and trustees. The Supreme Court of Canada has led the common law world in adopting the more principled approach to defining fiduciary duties. Other jurisdictions later followed this court's lead. See *Guerin v. The Queen*, [1984] 2 S.C.R. 335, 384 (Can.); *Bristol & West Building Soc'y v. Mothew*, [1996] 4 All E.R. 698 (Eng. Ct. App.); *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991). The circumstances in which a reasonable expectation that one party will act in the best interests of the other will arise varies from jurisdiction to jurisdiction. The most common circumstances where this reasonable expectation arises are where such an undertaking is imposed by statute or by agreement; it can also arise where one party seeks advice from another party on a highly specialized field (e.g., law or medicine) in which the latter party has expertise. See *Galambos v. Perez*, 2009 SCC 48, [2009] 3 S.C.R. 247, ¶ 84 (Can.).

48. Though there has been some debate over whether the duty of care can be properly described as a “fiduciary” duty (as opposed to simply a tort or contractual duty), both Canada and the United States have recognized fiduciary duties of care, and the rest of the common law world appears to be moving in this direction. See Leonard I. Rotman, *Fiduciary Law's “Holy Grail”: Reconciling Theory and Practice in Fiduciary Jurisprudence*, 91 B.U. L. REV. 921, 959 (2011); Edward J. Waitzer & Douglas Sarro, *The Public Fiduciary: Emerging Themes in Canadian Fiduciary Law for Pension Trustees*, 91 CAN. BAR REV. 163, 178–79 (2012); *Futter v. Futter*, [2011] EWCA Civ 197, ¶ 127 (Eng. Ct. App.) (recognizing that “trustees’ duty to take relevant matters into account [in carrying out their responsibilities] is a fiduciary duty”); see also J.D. Heydon, *Are the Duties of Company Directors to Exercise Care and Skill Fiduciary?*, in *EQUITY IN COMMERCIAL LAW* 185 (Simone Degeling & James Edelman eds., 2005); Paul Miller, *A Theory of Fiduciary Liability*, 56 MCGILL L.J. 235, 283 (2011).

49. See *infra* note 77 and accompanying text.

can evolve over time. As a result, fiduciary law effectively places the onus on fiduciaries to reflect on their legal relationships and consider how to act in accordance with these duties. Fiduciaries that ignore this onus risk having standards of appropriate conduct articulated for them after the fact.

The social importance of fiduciary services, and hence fiduciary duties, has risen considerably over the past several decades. In 1983 Tamar Frankel noted that the United States was undergoing a transition from being a “contract society” (which values economic independence) to a “fiduciary society” (which values interdependence).⁵⁰ The recent financial crisis highlighted how interdependent the world has become, and how reliant we have all become on a sound financial sector—our fiduciary society has gone global.

Developments in the financial sector offer insight not only into the importance of fiduciary law but into its characteristics. For instance, nowhere is the flexibility of the duties of loyalty and care better illustrated than in the development of fiduciary duties as they have applied to financial services.

A. THE DUTY OF CARE

The duty of care requires a fiduciary to exercise its powers as a prudent person would in the circumstances.⁵¹ The definition of “prudence” with respect to the delivery of financial services has changed dramatically as our understanding of investment risk has developed.

Financial crises have played an important role in its development. In 1719, the British Parliament authorized trustees to invest in the South Sea Company.⁵² While Parliament thought that it was giving trustees and beneficiaries a chance to participate in the massive surge in the value of South Sea stock, this surge turned out to be a bubble. The following year, share prices fell by over 90 percent.⁵³ The English courts of equity reacted by redefining the meaning of prudence by adopting the “legal list” approach, whereby a prescribed list of “safe” investments (particularly government bonds and, later on, first mortgages) were presumptively viewed as prudent, while all other investments (particularly equities) were presumed to be imprudent.⁵⁴

In the United States, the Massachusetts courts adopted a more flexible approach, holding in the 1830 case *Harvard College v. Amory* that the prudent person rule simply required trustees to avoid “speculation” and to select investments by “considering the probable income, as well as the probable safety of the capital to be invested.”⁵⁵ New York, however, imported the legal list approach into

50. Frankel, *Fiduciary Law*, *supra* note 44, at 802.

51. See *Charitable Corp. v. Sutton*, 2 Atk. 400, 406, 26 Eng. Rep. 642, 645 (Ch. 1742); *In re Speight*, 22 Ch.D. 727, 739 (1883) (Eng. Ct. App.); see also Marcia M. McMurray, *A Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule*, 40 VAND. L. REV. 605 (1987).

52. 6 Geo. 1, c. 4, s. 23 (1719) (U.K.).

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

54. See *id.* at 643; GEORGE KEETON, *MODERN DEVELOPMENTS IN THE LAW OF TRUSTS* 46–62 (1971).

55. 26 Mass. (9 Pick.) 446 (1830).

American law in the 1869 case *King v. Talbot*.⁵⁶ Most states adopted the New York approach, either through legislation or through common law.⁵⁷

Legislatures and courts gradually expanded legal lists, eventually embracing some investment in equities. Though many trustees managed to structure the terms of their trusts so as to allow for a more flexible approach to investment, courts interpreted these terms restrictively. Overall, a highly conservative approach to investment persisted in the common law world well into the twentieth century.⁵⁸

Over time, the market environment made this approach impractical. The “safe” fixed income investments prescribed by the courts left investors vulnerable to inflation risk—a risk that became particularly salient with the hyperinflation of the period immediately following the Second World War. Trustees also learned that, over the long run, equities and foreign securities outperformed the “legal list” investments. Modern Portfolio Theory offered a new approach to assessing investment risk. It held that, rather than weighing the risk of a portfolio by looking at each individual investment in isolation, investors should weigh risk by looking at the portfolio as a whole. In other words, it was prudent—and generally beneficial—for investors to give some weight in their portfolio to high-risk investments (and thus achieve some exposure to the high returns these investments offered), provided these investments did not receive undue weight within the portfolio.

This enhanced understanding of prudent investing came to be reflected in legislation: the Uniform Prudent Investor Act in the United States (which was developed by the American Law Institute and has been adopted in most states), the Pensions Act 1995 in the United Kingdom, and various provincial trust statutes in Canada.⁵⁹ This legislation recast the prudent person rule as the “prudent investor” rule. Under this rule, no particular investment is per se off limits; rather, trustees are required to consider the portfolio as a whole and to ensure that the portfolio is appropriate for the investor, in that it is designed to generate a suitable rate of return without creating an undue risk of loss. Legislators also recognized that the growing complexity of financial markets made it practically impossible for trustees to manage a portfolio on their own. As such, these rules permitted the delegation of responsibility for investment management to third parties.

This approach produced its own perverse effects. Trustees concluded that they could avoid liability under this approach by adopting two strategies. First, they took pains to avoid “underperforming” the market in the short term, relying on

56. 40 N.Y. 76 (1869).

57. See W. Brantley Phillips, Jr., *Chasing Down the Devil: Standards of Prudent Investment Under the Restatement (Third) of Trusts*, 54 WASH. & LEE L. REV. 335, 341 (1997).

58. See John H. Langbein & Richard A. Posner, *Market Funds and Trust Investment Law*, 1976 AM. B. FOUND. RES. J. 1, 5–6; Langbein, *supra* note 53, at 645.

59. UNIF. PRUDENT INVESTOR ACT, §§ 2(b), (f), 7B U.L.A. 20 (2006); Pensions Act, 1995, c. 26, ss. 33 (1), 35, 36(2) (U.K.); Trustee Act R.S.O. 1990, c. T.23, s. 27(1) (Can.), amended by S.O. 1998, c. 18, sched. B, s. 16(1); Trustee Act, R.S.B.C. 1996, c. 464, ss. 15.1–15.6 (Can.), amended by S.B.C. 2002, c. 33, s. 23; Trustee Act, R.S.N.S. 1989, c. 479, ss. 3A–3F (Can.), amended by S.N.S. 2002, c. 10, s. 45; Trustee Act, R.S.P.E.I. 1988, c. T-8, ss. 2–3.5 (Can.), amended by S.P.E.I. 1997, c. 51, s. 1.

the assumption that price is always the best guide to value and that those who fell behind the market, even on a quarterly basis, could face liability for failing to generate appropriate returns. Second, in part to mitigate their liability exposure, they took full advantage of the delegation rule, relying heavily on an ever-expanding chain of advisers, managers, and consultants.⁶⁰

These strategies fostered a herding mentality, whereby trustees, along with the interconnected web of actors that trustees delegated authority to, all too often acted as *closet indexers*, “trading in and out of the same stocks frequently to show activity, but overall just following the index to avoid any years of significant underperformance.”⁶¹ This means crowding into investments fueled by “irrational exuberance” rather than real value, only to exit these investments the minute portfolio performance began to fall. While this dynamic of “perpetual investors making short-term investments forever”⁶² might help trustees avoid scrutiny on a quarterly basis, on a long-term basis it all too often means that trustees are “buying high and selling low.”⁶³

This sort of short-termism, encouraged by regulatory frameworks, has implications that reach beyond any particular fund. It creates volatility,⁶⁴ destroys long-term value, makes markets less efficient, and impedes efforts to improve corporate governance by misaligning asset owner and investor goals.⁶⁵ It also ignores the arbitrage opportunities available to those with a longer investment horizon.⁶⁶

It is now broadly accepted that most investment returns come from general exposure to the market (beta) rather than from seeking market benchmark out-performance strategies (alpha).⁶⁷ As a result, systemic market factors have become critical to fiduciary responsibility. Investments are increasingly expected to look past current market benchmarks and consider questions of future value—to “assess the impact of their investment decisions on others including

60. See James Hawley, Keith Johnson & Ed Waitzer, *Reclaiming Fiduciary Duty Balance*, ROTMAN J. INT'L PENSION MGMT., Fall 2011, at 4, 9; Fiona Stewart & Pablo Antolin, *Supervisory Oversight of Pension Fund Governance* (Int'l Org. of Pension Supervisors Working Paper No. 9, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1809823.

61. Dominic Barton & Mark Wiseman, Address to the Institute of Corporate Directors in Toronto, Canada: Focusing Capital on the Long Term 4 (May 22, 2013), available at <http://goo.gl/3dVj7S>.

62. SIMON ZADEK, MIRA MERME & RICHARD SAMANS, MAINSTREAMING RESPONSIBLE INVESTMENT 19 (2005), available at <http://www.weforum.org/pdf/mri/pdf> (quoting a comment by Simon Zadek in his presentation at the International Corporate Governance Network's July 2004 Annual Conference in Rio de Janeiro, Brazil).

63. David F. Swensen, *The Mutual Fund Merry-Go-Round*, N.Y. TIMES, Aug. 14, 2011, at SR6; see also Paul Woolley, Written Evidence Submitted to the Business, Innovation and Skills Committee, U.K. House of Commons (Feb. 25, 2013), available at <http://www.publications.parliament.uk/pa/cm201314/cmselect/cmbs/603/603we26.htm>.

64. See Hawley, Johnson & Waitzer, *supra* note 60, at 7.

65. CFA CTR. FOR FIN. MKT. INTEGRITY & BUS. ROUNDTABLE INST. FOR CORPORATE ETHICS, *BREAKING THE SHORT-TERM CYCLE 4* (2006) [hereinafter *BREAKING THE SHORT-TERM CYCLE*].

66. See Michael W. Roherge, Joseph C. Flaherty, Jr., Robert M. Almeida, Jr. & Andrew L. Boyd, *Lengthening the Investment Time Horizon 2* (MFS White Paper Series, May 2014), available at <http://goo.gl/26urJ5>.

67. See Roger Ibbotson, *The Importance of Asset Allocation*, FIN. ANALYSTS J., Mar.–Apr. 2010, at 18, 20.

generations to come.”⁶⁸ Risk management means considering such factors as market integrity, systemic risks, governance risks, advisor risks, and the like. There is also a growing recognition that asset classes of longer duration often yield the highest private (as well as societal) returns.⁶⁹

Yet the mismatch between heightened expectations and suboptimal results persists. One of the likely reasons for this is that so many players in the investment chain benefit from the status quo. Managers of actively managed funds collect high fees in return for their promise to help investors beat the market, even when they consistently fail to deliver.⁷⁰ Financial advisors and brokers receive incentives from third parties to recommend high-cost investment strategies to their clients based on short-term performance metrics.⁷¹ The financial sector continues to be an environment where the “food chain operates in reverse, with service providers at the top and clients at the bottom.”⁷²

Tolerance for this dynamic is waning. In a sense, we have drifted away from the most fundamental meaning of fiduciary duty, which is to preserve the assets entrusted to the fiduciary.⁷³ *Harvard College v. Amory* says nothing about matching or beating benchmarks—that is a recent concept. If one thinks of preserving assets as meaning to protect them from inflation, it is but a small step to include protecting them from a degenerating environment and society. In formulating new norms to govern the financial sector, legislators, regulators, and courts are increasingly relying on this view of investor “prudence” which is enhanced by a renewed focus on the fiduciary duty of loyalty, which we now address.

B. THE DUTY OF LOYALTY

The duty of loyalty—to act in the best interests of beneficiaries—has long been recognized as the “cardinal duty” in the fiduciary relationship,⁷⁴ such that, where a conflict arises between the duty of care and the duty of loyalty, the conflict must be resolved in favor of the duty of loyalty.⁷⁵ This duty has historically been described narrowly, as implying only a duty to avoid conflicts of interest or to disclose such conflicts to the beneficiaries.⁷⁶ It has also been argued, however, that this duty is best framed as a broad, positive duty to “actively pursue”

68. Steve Lydenberg, *Reason, Rationality and Fiduciary Duty*, 119 J. BUS. ETHICS 365, 375 (2014).

69. See Andrew Haldane & Richard Davies, *The Short Long: Presentation Before the Société Universitaire Européenne de Recherches Financières Colloquium: New Paradigms in Money and Finance?* 14 (May 2011), available at <http://goo.gl/Dn6K85>.

70. Burton G. Malkiel, *Asset Management Fees and the Growth of Finance*, 27 J. ECON. PERSP. 97, 105 (2013).

71. FINRA, *REPORT ON CONFLICTS OF INTEREST* 10, 39 (2013), available at <http://goo.gl/YOwSqC>.

72. AMIN RAJAN, *DB & DC PLANS: STRENGTHENING THEIR DELIVERY* 22 (2008).

73. See *supra* note 54.

74. Paul Miller, *A Theory of Fiduciary Liability*, 56 MCGILL L.J. 235, 270 (2011).

75. Arthur B. Laby, *Resolving Conflicts of Duty in Fiduciary Relationships*, 54 AM. U. L. REV. 75, 125 (2004).

76. See, e.g., *Breen v. Williams* (1996), 186 C.L.R. 71 (Austl.); *Pilmer v. Duke Group* (in liq.), [2001] HCA 31, 207 C.L.R. 165 (Austl.); Pamela F. Hanrahan, *The Fiduciary Idea in Financial Services Law*, in *INTEGRITY, RISK AND ACCOUNTABILITY IN CAPITAL MARKETS: REGULATING CULTURE* 203, 214–16 (Justin O’Brien & George Gilligan eds., 2013).

the best interests of beneficiaries.⁷⁷ Under this view, the duty of care is best viewed as a component of the duty of loyalty, and as a result should be interpreted in light of this overarching duty.

The narrower view of the duty of loyalty is incapable of achieving fiduciary law's goal of encouraging trust in specialized service providers. Disclosure has been shown to be an imperfect tool for managing conflicts,⁷⁸ and while the avoidance of conflicts is a necessary step toward reinforcing trust in financial markets, it is not sufficient. It is also necessary to take into account the pernicious effects of short-termism, highlighted above. Regulators and courts have increasingly taken notice of this narrower view.⁷⁹ As a result, for fiduciaries to accurately predict and respond to the course of future regulation, they will need to look to the broader account of the duty of loyalty.

The Supreme Court of Canada's jurisprudence on the duty of loyalty offers a perspective of how this view works in practice. In *BCE Inc. v. 1976 Debentureholders*,⁸⁰ the Court reviewed a claim by bondholders who alleged that the board of BCE Inc. had not adequately considered their interests before agreeing to a change-of-control transaction. The Court, in upholding the board's decision, held that, in executing its duty of loyalty to the corporation, the board was required to reflect on the interests of the corporation both as an economic actor and as a "good corporate citizen."⁸¹ The Court added that, in doing so, it was legitimate for directors to consider not only the interests of shareholders and creditors, but also broader social interests, including those of the environment.⁸²

In other words, it was not enough for the board to avoid conflicts of interest—it had to actively exercise its powers in the best interests of its beneficiary, the corporation, viewed both as an economic actor and as a responsible citizen. In

77. Hanrahan, *supra* note 76, at 220; see also Claire A. Hill & Brett H. McDonnell, *Disney, Good Faith and Structural Bias*, 32 J. CORP. L. 833, 855 (2007).

78. Compare Daylian M. Cain, George Loewenstein & Don A. Moore, *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 24 J. LEGAL STUD. 1 (2005) (which concludes that consumers often ignore disclosure of conflicts of interest, or insufficiently discount them), with Sunita Sah & George Loewenstein, *Nothing to Declare: Mandatory and Voluntary Disclosure Leads Advisors to Avoid Conflicts of Interest*, 25 PSYCH. SCI. 575 (2014) (which suggests that disclosure requirements may help reduce the number of avoidable conflicts of interest, particularly if service providers are motivated to develop and maintain a reputation for ethical behavior). The link Sah & Loewenstein draw between reputational concerns and the effectiveness of disclosure provides further support for the proposition that a change in culture within the financial sector will lead to better outcomes for consumers.

79. See Financial Reporting Council Tribunal Report, *supra* note 30, ¶¶ 35–36 (noting that auditors "should strive for objectivity in all professional and business judgments" and should consider "the public interest and its bearing on the work [they are offered]"); *CDX Liquidating Trust v. Venrock Assocs.*, 640 F.3d 209, 218–19 (7th Cir. 2011) (concluding that, under Delaware law, disclosure of a conflict of interest will not immunize that director from a claim for breach of fiduciary duty; implicit in this conclusion is the understanding that disclosure of a conflict of interest by a fiduciary does not necessarily protect a beneficiary from self-interested behavior by that fiduciary); *In re Rural Metro Corp. Stockholders Litig.*, 88 A.3d 54, 80 (Del. Ch. 2014) (noting that corporate directors, as fiduciaries, are required to "act prudently, loyally, and in good faith to maximize [the company]'s value over the long-term for the benefit of its stockholders").

80. 2008 SCC 69, [2008] 3 S.C.R. 560 (Can.).

81. *Id.* ¶ 66.

82. *Id.* ¶ 40.

practice, we suggest this means that fiduciaries must exercise their powers in accordance with the law and must generally avoid conduct that is unethical or that otherwise does not reflect prevailing social norms.⁸³ When a fiduciary invests on behalf of, or provides advice to, a client, that fiduciary must treat that client (and everyone who invests or otherwise has an interest in that client) fairly and equitably. This “duty of impartiality” requires fiduciaries to consider and balance the divergent interests of these beneficiaries.⁸⁴ Fiduciaries charged with managing and advising investment vehicles that encompass multiple generations of beneficiaries, like pension plans, must therefore consider the intergenerational implications of their decisions (or advice).⁸⁵ This, in effect, imports the principle of intergenerational equity into the duty of loyalty.⁸⁶

Guidance can also be found in the definition of the duty of loyalty adopted in the American “public trust doctrine.” This doctrine starts from the premise that social and economic progress depend on a common infrastructure—and that, as such, the preservation of this infrastructure for future generations is a vital public goal. The public trust doctrine has aimed to achieve this goal by imposing on government a duty to preserve natural resources for the use and enjoyment of future generations. While the present generation is entitled to reasonable use of these resources, any use that interferes with the rights of future generations is prohibited.⁸⁷

The principles underlying the public trust doctrine are easily translated to the financial world. Investors rely on a common infrastructure: stock markets that should offer investors fair and equitable access to the capital markets; investment managers, consultants, and advisers who should be trusted to act in the best interests of their clients; companies that should adhere to sound corporate governance principles that foster long-term growth; and a sustainable natural environment capable of facilitating further human progress. If this infrastructure is allowed to fail, all investors, present and future, will lose. The duty of loyalty, as it is increasingly envisioned by courts, regulators, and legislators, imposes a similar resulting obligation on financial actors to preserve and continue to

83. Attempting to define “prevailing social norms” will always be a challenge. Consultation with an institution’s stakeholders is one means of ascertaining prevailing social norms; many authors have suggested additional means by which an institution can address this challenge, including by looking to scientific evidence and transnational standards that emerge from broad and meaningful dialogue. See Steve Lydenberg, *Ethics, Politics, Sustainability and the 21st Century Trustee*, in *SOCIALLY RESPONSIBLE INVESTMENT IN THE 21ST CENTURY: DOES IT MAKE A DIFFERENCE FOR SOCIETY?* 197 (Celine Louche & Tessa Hebb eds., 2014).

84. RESTATEMENT (THIRD) OF TRUSTS § 78 (2007); *Edge v. Pensions Ombudsman*, [1998] Ch. 512, *aff’d*, [1999] EWCA Civ 2013, 4 All E.R. 546 (Eng. Ct. App.).

85. See *Withers v. Teacher’s Ret. Sys. of N.Y.C.*, 447 F. Supp. 1248, 1257–58 (S.D.N.Y. 1978); see also *Varity Corp. v. Howe*, 516 U.S. 489 (1996).

86. See, e.g., *Bennett v. British Columbia*, 2009 BCSC 1358, 77 C.C.P.B. 56 (B.C. Sup. Ct.); *B.C. Nurses’ Union v. Mun. Pension Bd. of Trs.*, 2006 BCSC 132, 50 C.C.P.B. 77 (B.C. Sup. Ct.).

87. See Mary Christina Wood, *Advancing the Sovereign Trust of Government to Safeguard the Environment for Present and Future Generations (Part I): Ecological Realism and the Need for a Paradigm Shift*, ENVTL. L., Mar. 2009, at 43; Mary Christina Wood, *Advancing the Sovereign Trust of Government to Safeguard the Environment for Present and Future Generations (Part II): Instilling a Fiduciary Obligation in Governance*, ENVTL. L., Mar. 2009, at 91.

develop this infrastructure for the public good. This concept is acknowledged by leaders in the sector. Consider, for example, a recent op-ed column by the CEO of the Royal Bank of Scotland, in which he catalogued the company's past failings and pledged to turn around its culture by "starting to *build* a bank the country can truly be proud of."⁸⁸

In summary, the duty of loyalty requires fiduciaries to take proactive steps to invest (and encourage investment) for the long term, in a way that serves the best interests of their beneficiaries. This means charting a course for investment that takes account of important social and economic challenges, including effective corporate governance, human rights, and sustainable development.

POLICY PROPOSALS

Below, we describe strategies that financial institutions could follow to take into account these expectations and responsibilities. We also discuss ways in which regulators and legislators may encourage institutions to adopt these strategies.

If one theme unites these proposals, it is a call for a shift in emphasis from *reactive* regulatory and compliance strategies to *proactive* ones. In other words, rather than satisfying themselves with a "check box" or "is it legal" approach to compliance, institutions should anticipate future risks and consider how they may be expected to respond to these risks. Beyond compliance, there is an urgent need for the financial sector to re-assert its social utility. Regulators, in turn, should shift from a strategy of imposing detailed, complex rules that simply respond to past failures, to strategies that do a better job of encouraging institutions to think about and mitigate emerging long-term risks. Because no single institution can address these risks acting alone, we also propose deeper collaboration between different players in the financial sector—particularly large issuers and investors.

A. THE FIDUCIARY OF THE FUTURE

Those who study success factors in capitalism stress the importance of sustaining countervailing centers of power to balance and constrain private action.⁸⁹ In this context, the duty of loyalty to beneficiaries—extending beyond short-term returns to broader issues—may be a requisite counterweight to "thin" political markets, where the capacity to agree and deliver on needed change has been relatively low.⁹⁰

This raises the following question for institutional leaders: if evolving social norms and rising public expectations are becoming the driving force behind the transition to sustainable economics and supportive financial systems, would

88. Ross McEwan, Op-Ed., *Changing the Soul of RBS*, GUARDIAN, Feb. 10, 2014, at 24.

89. See Peter A. Hall & David Soskice, *An Introduction to Varieties of Capitalism*, in VARIETIES OF CAPITALISM: THE INSTITUTIONAL FOUNDATIONS OF COMPARATIVE ADVANTAGE 1 (Peter A. Hall & David Soskice eds., 2001).

90. See Rebecca Henderson & Karthik Ramanna, *Managers and Market Capitalism* 24 (Harvard Bus. Sch. Working Paper No. 13-075, Nov. 9, 2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2231526.

they rather help to guide this evolution, or be constrained by it? If institutions continue to take a reactive approach, they will all but guarantee that the present pattern of increasingly punitive fines, more complex regulation (which drives up compliance costs), and dissolving public confidence in the financial sector will continue. This pattern is not in the best interests of the individuals who rely on financial services. As such, the duty of loyalty implies a proactive response, carried out in accordance with the following broad principles.

First, the fiduciary of the future will need to be an ethical fiduciary: one that recognizes and follows through on its responsibility to preserve and build on the institutional system in which the fiduciary is embedded, and on which the fiduciary relies. The financial sector generates wealth by directing resources to individuals and organizations that can do something constructive with them. These individuals and organizations rely on more than investment for their enterprises to succeed—their success is predicated on, among other things, a natural environment capable of sustaining their operations, an education system that prepares that enterprise's potential labor base for the workforce, and a stable, equitable economy capable of sustaining a strong consumer base for the enterprise's products or services. Absent this social and environmental infrastructure, the financial sector would have enormous difficulty finding worthwhile investment opportunities. This implies a normative duty to help preserve this infrastructure by ensuring that externalities are properly priced and moral failures are addressed.⁹¹ The financial sector should be leading in developing efficient pricing mechanisms and better framing such failures.

Recall that *Harvard College v. Amory*⁹² spoke to the preservation of capital. In today's context, the challenge in doing so is protecting against the ravages of a degenerating environment and society—objectives that need to be achieved if public trust and confidence in fiduciary services are to be preserved.

Second, these circumstances also imply an obligation to take a more integrative approach to investment. Fiduciaries will be expected to identify and take advantage of opportunities to mobilize and allocate more of the capital and intellectual resources they control for broader social, economic, and environmental goals as part of their investment strategy. In many cases, this will mean seeking out and investing in existing asset classes, but it may also mean devising new ones, and new markets for these asset classes.⁹³

This will require a shift from the zero-sum culture that has crept into finance—where clients are seen as counterparties and the overriding assumption is that for the service provider to “win,” the client will “lose”—toward a fiduciary culture, where service providers place a premium on treating clients fairly and where the goal is to win *with* clients rather than to win *against* them. The endpoint is a financial sector imbued with a clearly articulated and generally accepted public

91. See *id.* at 28.

92. 26 Mass. (9 Pick.) 446 (1830).

93. An integrative approach can be applied to governance as well as investment. See UNITED NATIONS ENV'T PROGRAMME FIN. INITIATIVE, INTEGRATED GOVERNANCE: A NEW MODEL FOR SUSTAINABILITY (2014), available at <http://goo.gl/AiZJou>.

purpose and perceived of as a contributor, rather than extractor, of value. A number of recent reports, most prominently the 2013 Salz Review of business practices at Barclays Bank, have highlighted the need for such a change in culture.⁹⁴ Others have pointed to the business case for a culture of “integrity,”⁹⁵ noting a causal relationship between such a culture and long-term performance.⁹⁶

Some have wondered whether this kind of change is possible. They point to the “codes of conduct” promulgated by financial institutions in the years preceding the crisis, which failed to change these institutions’ behavior in any significant way.⁹⁷ It is clear that the proliferation of codes of conduct has failed to address the problems underlying the financial system. But this does not mean that cultural change is impossible. Rather, it indicates that cultural change cannot be achieved simply by putting a code of conduct on the books.

To understand why codes of conduct fail to achieve a change in culture, and why this failure does not mean that any effort at cultural change is futile, it is necessary to briefly explain what we mean by “culture.” Culture consists of a set of values, assumptions, and behaviors shared by a group of people.⁹⁸ Culture influences the way in which managers set priorities and make hiring decisions. It influences how employees react to new markets and new financial technologies. It influences whether they see regulators as adversaries or as partners. In this way, culture can itself be seen as a form of regulation—a means by which an organization can influence the actions of its employees to achieve shared goals.⁹⁹ When we view past attempts at effecting cultural change within the financial sector through this prism, it becomes easier to understand why these efforts have not succeeded.

Self-regulation has three elements: standard setting, monitoring, and enforcement.¹⁰⁰ For our purposes, standard setting refers to the creation of written

94. See ANTHONY SALZ, SALZ REVIEW: AN INDEPENDENT REVIEW OF BARCLAYS’ BUSINESS PRACTICES (2013) [hereinafter SALZ REVIEW]; JOHN KAY, THE KAY REVIEW OF UK EQUITY MARKETS AND LONG-TERM DECISION MAKING: FINAL REPORT (2012).

95. See, e.g., Werner Erhard & Michael C. Jensen, *Putting Integrity into Finance: A Purely Positive Approach* (European Corporate Governance Inst., Fin. Working Paper No. 12-074, 2014), available at <http://ssrn.com/abstract=1985594>.

96. Luigi Guiso, Paola Sapienza & Luigi Zingales, *The Value of Corporate Culture* 22 (Univ. of Chicago Booth Sch. of Bus., Working Paper No. 13-80, 2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2353486.

97. See, e.g., John Cassidy, *Why Do Banks Go Rogue: Bad Culture or Lax Regulation?*, NEW YORKER ONLINE (Apr. 5, 2013), <http://goo.gl/vl6E4K>.

98. Culture has been defined in a number of ways, though these definitions tend to focus on shared values, assumptions, and behaviors. See, e.g., OXFORD DICTIONARY OF ENGLISH (3d ed. 2010) (“the ideas, customs, and social behavior of a particular people or society”); *What Is Culture?*, CTR. FOR ADVANCED RES. ON LANGUAGE ACQUISITION, <http://www.carla.umn.edu/culture/definitions.html> (last visited July 14, 2014) (“shared patterns of behaviors and interactions, cognitive constructs, and affective understanding that are learned through a process of socialization”); DAVID G. BATES & FRED PLOG, CULTURAL ANTHROPOLOGY 7 (2d ed. 1990) (“[t]he system of shared beliefs, values, customs, behaviors, and artifacts that the members of society use to cope with their world and with one another, and that are transmitted from generation to generation through learning”).

99. See Charles A. O’Reilly & Jennifer A. Chatman, *Culture as Social Control: Corporations, Cults, and Commitment*, 18 RES. ORG. BEHAV. 157 (1996).

100. See CHRISTOPHER HOOD, HENRY ROTHSTEIN & ROBERT BALDWIN, THE GOVERNMENT OF RISK: UNDERSTANDING RISK REGULATION REGIMES 24–28 (2001); Colin Scott, *Regulating Everything: From Mega- to Meta-regulation*, 61 ADMIN. 61, 67–68 (2012).

codes of conduct or ethical principles to govern an organization and their communication throughout all levels of an organization. Monitoring is the means by which an organization tracks compliance with these standards. Effective monitoring can occur only if managers at all levels of the organization understand and support the applicable standards and develop ways of keeping track of whether those under their supervision uphold these standards in their work. In the case of firm or industry self-regulation, enforcement takes on a different meaning than it does in the general regulatory context, as it refers primarily to rewards rather than punishments. An organization enforces its standards by rewarding employees who uphold these standards, whether through compensation, career advancement, or some other form of recognition.

Establishing a code of conduct only gets one past the standard-setting stage. To see why standard-setting is not enough one need only look at the experience Barclays has had with codes of conduct, as documented in the Salz Review. Different businesses adopted different codes emphasizing different values. As a result, there were no clear, universal standards for Barclays' employees to look to.¹⁰¹ Further, these codes were not communicated effectively within the organization—most employees were unaware of their existence.¹⁰² There was no discernible effort to ensure managers supported these codes or integrated them into their monitoring of their subordinates.¹⁰³ Insufficient thought appears to have been given to how the company's reward system should be used to reinforce these standards.¹⁰⁴ If anything, the reward system, which tended to emphasize immediate financial returns above all else, tended to undermine these standards.¹⁰⁵

In other words, while skeptics would be right to note that the adoption of a code of conduct will not in itself change an organization's culture, it would be wrong to argue that the failure of these codes of conduct automatically means that cultural change is impossible. Rather, this failure calls for a more complete and more serious effort at cultural change.

What would a roadmap for a shift from a zero-sum culture to a fiduciary culture look like? It would *begin* with a clear statement of principles that apply throughout an organization. The ten Investment Beliefs adopted in the fall of 2013 by CalPERS, the \$266 billion California Public Employee Retirement System, offers a model. The purpose of these beliefs is made clear from the outset: "to provide a basis for strategic management of the investment portfolio, inform organizational priorities, and ensure alignment between the Board and CalPERS staff."¹⁰⁶

The principles reflect an enlightened understanding of the relationship between the generation of wealth, sound institutions, and a sustainable environment. For instance, Investment Belief 2 states that "[a] long time investment horizon is a

101. SALZ REVIEW, *supra* note 94, ¶ 8.14.

102. *Id.* ¶ 8.17.

103. *Id.* ¶¶ 8.18–8.19.

104. *Id.* ¶ 8.18.

105. *Id.* ¶ 11.40.

106. CALPERS, CALPERS INVESTMENT BELIEFS 1 (2013).

responsibility and an advantage.”¹⁰⁷ In light of this belief, CalPERS pledges to “[c]onsider the impact of its actions on future generations of members and taxpayers,” “[f]avor investment strategies that create long-term sustainable value,” and “[a]dvocate for public policies that promote fair, orderly and effectively regulated capital markets.”¹⁰⁸ Investment Belief 9 concedes that “[r]isk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error.”¹⁰⁹ To address this, CalPERS commits to “consider risk factors, for example climate change and natural resource availability, that emerge slowly over long time periods, but could have a material impact on company or portfolio returns.”¹¹⁰

Similar standards should be adopted throughout the financial sector. However, the adoption of standards is not enough. For one, these standards also need to be communicated. This effort must begin with the board and the CEO—as the leaders of the organization, they play a central role in defining the culture of that organization.¹¹¹ Further, for these standards to be taken seriously, the board and CEO will need to communicate them through actions as well as words—they must set an example by showing how they are adapting their behavior in light of these standards.¹¹² Only then will change start to filter through the organization. Recent history shows that delegating this task entirely to an institution’s compliance or risk management department is not a strategy that is likely to succeed—risk management and compliance staff can only be effective if they have the confidence and clear backing of an institution’s leadership and, in turn, its management.¹¹³ Otherwise, they will be powerless to prevent unethical or self-destructive conduct by employees.¹¹⁴

Monitoring mechanisms can be developed through a similar approach. As management comes to understand how the new standards serve the interests and purpose of the organization, these standards will start to play a larger role in the way managers monitor their subordinates day-to-day. The board should supplement this informal change by embedding them into CEO performance metrics and compensation plans. This process should continue until there are effective monitoring mechanisms at all levels of the organization. This reflects the widely acknowledged understanding that line management is the “first line of defence” against corporate misconduct.¹¹⁵

Enforcement, as noted, should take the form of rewards rather than punishments. Within an organization, the most powerful reward is likely advancement.

107. *Id.* at 2.

108. *Id.*

109. *Id.* at 6.

110. *Id.*

111. See ROBERT J. HOUSE ET AL., *CULTURE, LEADERSHIP, AND ORGANIZATIONS: THE GLOBE STUDY OF SOCIETIES* 62 (2004); EDGAR H. SCHEIN, *ORGANIZATIONAL CULTURE AND LEADERSHIP* xi (4th ed. 2010).

112. See Bradley P. Owens & David R. Heckman, *Modeling How to Grow: An Inductive Examination of Humble Leader Behaviors, Contingencies, and Outcomes*, 55 *ACAD. MGMT. J.* 787 (2012).

113. Kate Kenny, *Banking Compliance and Dependence Corruption: Towards an Attachment Perspective* 14–16, 19–22 (Edmond J. Safra Working Paper No. 38, Mar. 6, 2014), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2405615.

114. See, e.g., SALZ REVIEW, *supra* note 94, ¶ 2.33.

115. See, e.g., PAUL HOPKIN, *RISK MANAGEMENT: CONCEPTS AND GUIDANCE* 192 (2013).

Clear, demonstrated commitment to ethical standards should be a crucial factor in making promotion decisions.¹¹⁶ In this way, an organization can both demonstrate that it values compliance with these standards and ensure that its senior management is populated by people who will continue to develop and place a premium on them. Compensation may be another motivator although research indicates that “pay for performance” mechanisms may be less effective than one would assume.¹¹⁷ In any event, an organization should ensure that its compensation mechanisms do not work at cross-purposes with new standards (for example, by encouraging short-termism). If pay for performance is retained, it should be oriented toward long-term performance and be explicitly engineered to reward prudence and a commitment to sustainability. Likewise, one might constitute a board committee to focus on long-term issues and to be the advocate for the long-term sustainability of the enterprise. The scale of the challenge ahead cannot be underestimated. The leading institutions involved in the financial sector are large and highly complex. They cannot be changed overnight. But the imperative for change also cannot be overlooked—the alternative to proactive change from within the financial sector is continued reactive, punitive action from regulators, along with dissolving public confidence in critical fiduciary institutions.

B. COLLABORATION

Sound, sustainable governance requires an investment. One can understand why issuers and investors would be reticent to make these investments unilaterally. It is challenging for an institutional investor to compete for investors seeking a low-cost investment vehicle while at the same time incurring the short-term costs necessary to improve the way their portfolio companies are governed.¹¹⁸ An issuer is unlikely to incur the costs necessary to ensure better governance without being assured that it has the support of its largest investors. It is therefore unsurprising that, even though a culture of integrity appears to add value, on average such cultures are weaker among public companies.¹¹⁹

This is what game theorists would call a “trust dilemma.”¹²⁰ The short-term benefits of “defecting”—refusing to make the necessary investment until someone else steps up—outweigh the short-term benefits of being the first to contribute. The way out of the trust dilemma is cooperation: players of the game can win if they agree to share the short-term costs necessary to make the investment. Over time, as institutions interact in a repeated and consistent manner with one

116. See, e.g., SALZ REVIEW, *supra* note 94, ¶ 8.64.

117. See, e.g., Dan Ariely et al., *Large Stakes and Big Mistakes*, 76 REV. ECON. STUD. 76 (2009); Ronald Benabou & Jean Tirole, *Intrinsic and Extrinsic Motivation*, 70 REV. ECON. STUD. 489 (2003); Edward L. Deci, Richard M. Ryan & Richard Koestner, *A Meta-Analytic Review of Experiments Examining the Effects of Extrinsic Rewards on Intrinsic Motivation*, 125 PSYCHOL. BULL. 659 (1999); see also Martin Dewhurst, Matthew Guthridge & Elizabeth Mohr, *Motivating People: Getting Beyond Money*, MCKINSEY Q., Nov. 2009, at 1.

118. See Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 894–95 (2013).

119. See Guiso, Sapienza & Zingales, *supra* note 96, at 8.

120. See WILLIAM POUNDSTONE, PRISONER'S DILEMMA 219 (1992).

another, trust develops into the default option—in other words, past trust provides the social glue that makes continued trust easier.

Collaboration is therefore essential to solving the challenges that threaten our economy and our society. It drives more efficient and resilient use of resources and deeper connectivity—personal and institutional. To some extent, coalitions seeking to achieve better governance already exist. Some of these coalitions are global in scope. The International Corporate Governance Network, an “investor-led organization” with a membership of roughly 600 “leaders in corporate governance” including institutional investors that collectively represent funds under management of around \$18 trillion, is one example.¹²¹ The signatories to the United Nations Principles for Responsible Investment, which include over 1,200 asset owners, investment managers, and professional service partners, form another important, global group.¹²² There are other investor-led coalitions with similar mandates that operate on a regional level, including Eumedion in Europe, the Collective Engagement Working Group in the United Kingdom, the U.S.-based Council of Institutional Investors, the Canadian Coalition for Good Governance, and the Australian Council of Superannuation Investors.

These coalitions fulfill an important role. Their broad-based membership, concentrated within the investment community, gives them a mandate to represent the interests of this community in dialogue with public companies and with government. They have produced thoughtful proposals for governance reforms and used their collective suasion to effect meaningful changes in regulation and behavior.¹²³

We believe that the efforts of these organizations need to be supplemented by another model for collaboration, guided by three broad principles. First, that the only way to achieve the outcomes we seek is through collaboration between investment intermediaries and issuers. Too much of the dialogue over good governance has been one-sided: asset owners telling issuers how they ought to act. It is easy to understand why managers would respond defensively. The result is that a relationship that ought to be cooperative is too often seen by both sides as antagonistic or adversarial. It is only by seating both sides at the same table, as equal partners with a common agenda, that they can forge the kind of trust ne-

121. *About the ICGN*, INT'L CORP. GOVERNANCE NETWORK, <https://www.icgn.org/about-icgn> (last visited June 20, 2014); *Membership*, INT'L CORP. GOVERNANCE NETWORK, <https://www.icgn.org/membership> (last visited June 20, 2014).

122. *Signatories to the Principles on Responsible Investment*, UNITED NATIONS PRINCIPLES ON RESPONSIBLE INVESTMENT, <http://www.unpri.org/signatories> (last visited June 20, 2014).

123. See, e.g., COUNCIL OF INST. INVESTORS, U.S. FINANCIAL REGULATORY REFORM: THE INVESTORS' PERSPECTIVE 5–7 (2009), available at <http://goo.gl/h3QkiB> (proposing, among other things, that over-the-counter derivatives be traded on regulated exchanges, that “investment advisers and brokers who provide investment advice to customers” be subject to fiduciary standards, that the SEC’s position as overseer of credit rating agencies be strengthened, and that a systemic risk regulator be established); UNEP. FIN. INITIATIVE, PRINCIPLES FOR RESPONSIBLE INVESTMENT—LONG-TERM MANDATES: A DISCUSSION PAPER (2014), available at <http://goo.gl/uVuK8z> (this discussion paper marks the beginning of a consultation process with PRI members aimed at identifying best practices in adopting a long-term investment horizon); see also INT'L INST. SUSTAINABLE DEV., WHAT ARE INVESTOR COALITIONS DOING ON FINANCIAL REGULATORY REFORM? 6–12 (2013), available at <http://goo.gl/ye9dQW> (a summary of recent initiatives by investor coalitions on financial regulatory reform).

cessary to effect collaborative change. One promising initiative on this front may be the Conference Board's Task Force on Corporate/Investor Engagement, which has brought together a group of directors of public companies and investors in the United States to find solutions to help create a stronger corporate governance system through effective engagement.¹²⁴ Another is the SDX Protocol—the effort of a working group of independent corporate directors and institutional investors to develop a framework for shareholder-director engagements.¹²⁵

Second, it is likely that the only way to achieve timely, practical results is by working with a small group of leading players. Large groups have legitimacy, and they play an important role in defining social norms. But it is difficult for them to effect focused, practical action. Consider, for example, the United Nations General Assembly. The work of these groups needs to be complemented by that of smaller, more focused groups, whose members have the capacity to follow through on their proposals. In international politics, the G20 is an example of how effective such a group can be. It played a central role in framing the international response to the global financial crisis that began in 2008, because it was small enough to act nimbly and reach consensus quickly, but inclusive enough to ensure that its membership had the ability to transform consensus into meaningful change.¹²⁶

Third, such initiatives should be imbued with a sense of urgency, and they should not be allowed to outlive their usefulness. In its 2013 report *Now for the Long Term*, the Oxford Martin Commission for Future Generations recommended that we build sunset clauses into international institutions.¹²⁷ Without them, a coalition may feel less of a need to justify its continued existence by delivering on clear goals. It may take its continued existence for granted, and thus risk becoming largely self-congratulatory, with its members seeing membership as an end in itself rather than as merely a means of achieving change. Worse still, smaller groups are at risk of outliving their relevance—the fact that their members were important players at the time their coalition was formed is no guarantee that these members will continue to be important in ten or twenty years' time. The United Nations Security Council, whose permanent membership continues to reflect international politics as it existed in 1945, is an example of an institution that has been allowed to outlive the environment it was fitted to.¹²⁸

124. See *The Conference Board Task Force on Corporate/Investor Engagement*, CONFERENCE BOARD, <http://www.conference-board.org/taskforce> (last visited June 20, 2014); Arthur H. Kohn & Julie L. Yip-Williams, *The Separation of Ownership from Ownership*, DIRECTOR NOTES (Conference Bd., New York, N.Y.), Nov. 2013, at 1.

125. S'HOLDER-DIR. EXCH., INTRODUCTION AND PROTOCOL (Feb. 2014), available at <http://www.sdxpro.tocol.com/download/630/>.

126. John Kirton, *The Group of Twenty*, in *THE HANDBOOK OF TRANSNATIONAL GOVERNANCE: INSTITUTIONS AND INNOVATIONS* 55, 58 (Thomas Hale & David Held eds., 2011).

127. OXFORD MARTIN COMM'N FOR FUTURE GENERATIONS, *NOW FOR THE LONG TERM: THE REPORT OF THE OXFORD MARTIN COMMISSION FOR FUTURE GENERATIONS* 58 (2013) [hereinafter *NOW FOR THE LONG TERM*], available at <http://goo.gl/qRQluJ>.

128. See, e.g., Kenneth Anderson, *United Nations Collective Security and the United States Security Guarantee in an Age of Rising Multipolarity: The Security Council as the Talking Shop of the Nations*, 10 CHI. J. INT'L L. 55, 84 (2009).

Based on these principles, we propose a new coalition consisting of (say) ten of the largest investors in the world, ten of the largest issuers in the world, and ten of the largest financial intermediaries—a G30 for capital markets. This coalition would create an infrastructure for asset managers and issuers to identify and agree on key governance issues and to develop new industry standards and proposals for regulatory reform. It would have a limited time horizon to achieve its goals—between five and ten years—after which the group would be required to disband. The coalition would need to justify its renewal by reference to concrete accomplishments, and, if it is renewed, its membership would need to reflect current market realities.

Such a coalition would need to set its own priorities for change, but the group would likely be guided by the overarching objective of repairing the poisoned relationship between issuers and investors, where issuers accuse investors of being out to destroy company value to gain a short-term bump in share price and investors accuse issuers of destroying company value through subpar management and self-enrichment. It is time to move past the illusion that investors and issuers are on opposite sides. If anything, they represent opposite sides of the same coin.

There are signs that the protagonists of the opposing camps are starting to climb down from their battlements and are coming to understand the importance of engagement.¹²⁹ Direct collaboration between leading investors and issuers, with give and take on issues important to both constituencies, would be an important step in building trust and producing better outcomes for our capital markets and for society as a whole. Such a cooperative focus is more aligned with the longer-term, “fiduciary” orientation we have attempted to outline.

There are a number of specific challenges of interest to issuers and investors alike that such a group could easily address. While some of these challenges do not directly relate to the broader, more systemic issues we have identified in this article, working through them nonetheless achieves two related goals. First, cooperation on smaller issues builds trust, which can be called on to resolve more significant issues.¹³⁰ Second, resolving sources of conflict and distraction, however minor, frees up the intellectual and financial resources necessary to engage in longer-term thinking and to make better decisions for the long term.¹³¹

A starting point might be to find a way to reduce the number of frivolous shareholder lawsuits, which have become endemic in the United States, and deliver few tangible benefits to investors.¹³² The challenge to be addressed is how

129. See, e.g., David A. Katz & Laura A. McIntosh, *The Mainstreaming of Shareholder Activism in 2013*, N.Y. L.J. (Sept. 26, 2013), <http://goo.gl/Qeumhk>; Alexandra Stevenson, *No Barbarians at the Gate; Instead, a Force for Change*, N.Y. TIMES, Jan. 6, 2014, at B1.

130. See WORLD RES. INST., BUILDING INTERNATIONAL CLIMATE COOPERATION 22 (2012), available at http://pdf.wri.org/building_international_climate_cooperation.pdf.

131. Research on decision making by individuals indicates that sources of stress tend to lead individuals to make myopic decisions. See, e.g., Jeremy R. Gray, *A Bias Toward Short-Term Thinking in Threat-Related Negative Emotional States*, 25 PERS. SOC. PSYCHOL. BULL. 65 (1999).

132. A study by Cornerstone Research found that in 2012, 94 percent of M&A deals valued at over \$100 million, and 96 percent of M&A deals valued at over \$500 million, were challenged in court. Out of those lawsuits where Cornerstone could determine the outcome, 36 percent were

to better differentiate lawsuits without merit from those that address real wrongdoing and should be encouraged.¹³³

Another fertile ground for collaboration might be proposing ways of reforming executive compensation, in respect of both issuers and institutional investors, so that executives' pay better reflects the value they bring to the company, and so that it is more likely to encourage executives to act in the long-term interests of their firms. A more fundamental question that may be worth asking is whether "pay-for-performance" actually does influence executives' behavior, or whether other external pressures, like analysts' expectations and lower CEO job security, now play a greater role in shaping executives' behavior.¹³⁴

Likewise with proposing reforms to the shareholder proposal process to ensure that only those proposals that have a real chance of succeeding are allowed to make their way to a meeting of shareholders.¹³⁵ At present, shareholder meeting agendas are cluttered with proposals that enjoy little support and are certain to fail;¹³⁶ all they do is increase issuers' paperwork and time burdens—costs that are eventually passed on to investors.¹³⁷

Improving the quality of corporate disclosure is another broad issue of common concern. Corporate disclosures have become bloated and overly complicated. The purpose of disclosure was supposed to be to supply investors with important information about the issuer and how it is managed. In today's corporate disclosure, however, the "signal" is all too often buried in "noise."¹³⁸

dismissed, and 64 percent ended in settlement. Of those lawsuits that ended in settlement, less than 1 percent led to an increase in the merger price, while 81 percent—or four in five—delivered only additional disclosures and fees for plaintiffs' attorneys. Evidence from such settlements over the past several years indicates that this disclosure rarely, if ever, actually affects whether the deal closes. See ROBERT M. DAINES & OLGA KOURMIAN, *SHAREHOLDER LITIGATION INVOLVING MERGERS AND ACQUISITIONS* (2013), available at <http://goo.gl/TRfQuj>; see also Daniel Fisher, *Lawyers Challenge Almost Every Merger, Cornerstone Study Shows*, FORBES (Apr. 26, 2012), <http://goo.gl/Jzg1gq>; Joseph A. Grundfest & Kristen Savelle, *The Brouhaha Over Intra-Corporate Forum Selection Provisions: A Legal, Economic, and Political Analysis*, 68 BUS. LAW. 325 (2013); Marc Wolinsky & Ben Schiresons, *Deal Litigation Rum Amok: Diagnosis and Prescriptions*, REV. SEC. & COMMODITIES REG., Jan. 8, 2014, at 1.

133. Stephen M. Davidoff, *Corporate Takeover? In 2013, a Lawsuit Almost Always Followed*, N.Y. TIMES DEALBOOK (Jan. 10, 2014, 12:20 PM), <http://dealbook.nytimes.com/2014/01/10/corporate-takeover-in-2013-a-lawsuit-almost-always-followed/>.

134. See generally Andrew C.W. Lund & Gregg D. Polsky, *The Diminishing Returns of Incentive Pay in Executive Compensation Contracts*, 87 NOTRE DAME L. REV. 677 (2011).

135. The support threshold that must be met before a proposal can be included on the agenda is minimal—in most instances, the shareholders making the proposal need only have held \$2,000 worth of securities for a set period (one year in the United States and two years in Canada). The United Kingdom also provides for shareholder proposals, but the threshold for getting a proposal on the agenda of a shareholders' meeting is significantly higher than the one that applies in Canada and the United States. See 17 C.F.R. § 240.14a-8(b)(2) (2013); Canada Business Corporations Regulations, 2001, S.O.R./2001-512, s. 46 (Can.); Companies Act 2006, c. 46, ss. 314–317 (U.K.).

136. In the 2013 proxy season, only 13 percent of the shareholder proposals submitted to U.S. issuers passed. Of those proposals that focused on social or political issues, less than 1 percent succeeded. See SULLIVAN & CROMWELL LLP, 2013 PROXY SEASON REVIEW 2 (2013), available at <http://goo.gl/SbKi3Q>.

137. In the past, these "fringe" proposals may have been a helpful means to highlight important political and social issues. But today, they have largely been overtaken by day-to-day engagement between management and investors and other tools.

138. See Omri Ben-Shahar & Carl E. Scheider, *The Failure of Mandated Disclosure*, 159 U. PENN. L. REV. 101, 198 (2011); Mary Jo White, *The Path Forward on Disclosure: Remarks to the National As-*

At present, however, there is no consensus on how exactly the problems that have been identified with disclosure can be resolved. This does not mean that dialogue on this issue would be premature. In fact, such a dialogue is already starting to occur—in June 2014, the International Integrated Reporting Council, a broad-based coalition that includes regulators, investors, and companies, launched a new Corporate Reporting Dialogue that aims to “respond to market calls for better alignment and reduced burden in corporate reporting.”¹³⁹ Continued dialogue between issuers and investors on the issue of disclosure should itself help identify ways to make progress on this issue.

Sustainability has become a defining issue for businesses and policy makers, yet we continue to struggle to develop measurement systems and effectively embed them in management and decision-making processes.¹⁴⁰ This is as true for the investor community as for issuers—witness the continuing focus on quarterly earnings estimates and the lack of sell-side research that extends beyond the near term.¹⁴¹ In short order, this will no longer be due to a lack of appropriate metrics: existing standard-setters (generally accounting bodies and stock exchanges), industry coalitions (e.g., Carbon Disclosure Project, Sustainability Accounting Standards Board, International Integrated Reporting Initiative), and data vendors (e.g., Bloomberg, MSCI, rating agencies, and proxy advisory services) have been active in developing simple, relevant, comparable metrics designed to correlate with long-term corporate performance and sustainability. Rather, the key challenge will likely be to determine how to use these metrics to develop a common language and common standards for reporting on and evaluating sustainability.¹⁴² This is another area where a group of leading global issuers and investors could collaborate and in doing so accelerate the shift within our capital markets from a focus on reporting short-term financial results to one on an evolving set of widely accepted metrics that relate to long-term value creation.¹⁴³

Sustainability metrics can only influence issuers’ behavior through collaboration between investors and issuers. At present, issuers have strong incentives to underinvest in sustainability—paying the costs associated with making an issuer more sustainable can make that issuer less attractive relative to its competitors in the short run and give rise to discontent among investors. This dynamic might be

sociation of Corporate Directors 2013 Board Leadership Conference (National Harbor, Md., Oct. 15, 2013), available at <http://goo.gl/7hepdN>.

139. Press Release, Int’l Integrated Reporting Council, *Corporate Reporting Dialogue Launched, Responding to Calls for Alignment in Corporate Reporting* (June 17, 2014), available at <http://goo.gl/vHrxKP>.

140. See WORLD ECON. FORUM, DESIGNING FOR ACTION: PRINCIPLES OF EFFECTIVE SUSTAINABILITY MEASUREMENT 13–16 (2013) (which gives a typology of sustainability metrics developed since the Rio Earth Summit of 1992, while noting that there remain significant challenges involved in collecting many of the data sets important to sustainability assessment despite improvements in technology).

141. See BREAKING THE SHORT-TERM CYCLE, *supra* note 65, at 3–4, 7.

142. For lists of some of the leading metrics, see PETER A. SOYKA & MARK E. BATEMAN, FINDING COMMON GROUND ON METRICS THAT MATTER 27 (Feb. 2012), available at http://www.irrcinstitute.org/pdf/IRRC-Metrics-that-Matter-Report_Feb-2012.pdf; UNITED NATIONS ENV’T PROGRAMME: FREQUENTLY ASKED QUESTIONS ON CORPORATE SUSTAINABILITY REPORTING 10, 26 (2013), available at <http://goo.gl/YvjvmM>.

143. See, e.g., Dominic Barton & Mark Wiseman, *Focusing Capital on the Long Term*, HARV. BUS. REV., Jan.–Feb. 2014, at 44, 49–55.

changed if a critical mass of large issuers agrees to undergo these costs at the same time, and if large investors agree to support this move.

Investors should be prepared to give this support. As CalPERS CEO Anne Stausboll recently noted, “[a]s fiduciaries, it is our job to make sure investors, businesses, and policymakers are responding aggressively and creatively to the risks and opportunities associated with climate change and other sustainability issues.”¹⁴⁴ By developing high-level principles on the obligations of institutional investors in capital markets, which take into account these investors’ unique status as “universal owners”—investors with significant holdings across diverse industries and regions—institutions such as CalPERS can more effectively address how they should invest and how they should behave as owners.

C. LEGAL MECHANISMS TO PROTECT FUTURE GENERATIONS

Market failures are often reflected in failures of political systems. In particular, the problems that arise from the short-termist manner in which markets often function is likely amplified by the short-termism of our political systems.¹⁴⁵ Designing public institutions to counteract such systemic weaknesses is therefore another challenge that must be addressed. One model might be to establish a commissioner or ombudsperson for future generations, with the task of thinking about, consulting, and speaking up for those who cannot speak for themselves in the struggle to define public policy and regulatory mechanisms. A commissioner or ombudsperson would be an independent officer reporting directly to the legislature, and would be responsible for evaluating and reporting on the effects proposed laws and regulations may have on future generations, and have legal standing to challenge government actions that fail to take the interests of future generations into account.¹⁴⁶ Several countries have experimented with this model, including New Zealand, Israel, and Hungary.¹⁴⁷ The concept of an ombudsperson with a singular focus on preserving options for future generations could draw on similar mechanisms in respect of environmental and human rights that are well developed in many jurisdictions, including the United Kingdom’s Sustainable Development Commission, which is an independent watchdog charged with monitoring and reporting on the government’s progress in implementing its sustainable development strategy.¹⁴⁸

The work of an independent ombudsperson or commissioner dedicated to future generations could be supplemented by broader reforms throughout government

144. Press Release, Ceres, *While Washington Waits, Investors Act on Climate Change* (Jan. 12, 2012), available at <http://www.ceres.org/press/press-releases/while-washington-waits-investors-act-on-climate-change>.

145. See NOW FOR THE LONG TERM, *supra* note 127, at 45–47.

146. See SCI. & ENVTL. HEALTH NETWORK & INT’L HUMAN RIGHTS CLINIC AT HARVARD LAW SCH., *MODELS FOR PROTECTING THE ENVIRONMENT FOR FUTURE GENERATIONS* (2008), available at <http://goo.gl/v5wvP3>.

147. See Edith Brown Weiss, *Implementing Intergenerational Equity*, in RESEARCH HANDBOOK ON INTERNATIONAL ENVIRONMENTAL LAW 100, 110–11 (Malgosia Fitzmaurice, David M. Ong & Panos Merkouris eds., 2010).

148. See *supra* note 146.

that seek to minimize the influence short-term political interests have on government planning and priorities. More day-to-day decision making on issues that relate to sustainability, including infrastructure, health, and environmental protection, could be delegated to non-partisan, independent agencies, which would have sufficient power and discretion to resist short-term political pressure, but whose long-term priorities would continue to be defined by political institutions.¹⁴⁹ Assuming other effective accountability mechanisms, guaranteed term lengths for senior administrators, which extend beyond the traditional four-year election cycle, offer another means of securing independence from short-term political pressure. Such a reallocation of power would allow governments to “focus more on steering rather than rowing,”¹⁵⁰ and in turn condition officials on both the political and administrative ends of government to adopt a more long-term mindset.¹⁵¹

Another set of legal mechanisms that merit consideration are prophylactic rules which, like insurance, are a means of responding to risks that, while uncertain or seemingly remote, are too significant to ignore. They can set clear, simple standards that keep essential systems functioning while regulators learn more about a problem and determine whether a more nuanced solution ought to be imposed.¹⁵² In other words, they exist to prevent failure while regulators gather more information on a problem.¹⁵³ Regulators should have both the legal power and the confidence to impose these kinds of prophylactic mechanisms to deal with problems as they arise, before they have complete certainty as to the nuances of that problem.

Another avenue is cultural. For example, it is argued that the success of East Asian economies—most prominently China—owes a great deal to the long-term perspective built into the cultural values that prevail in this region.¹⁵⁴ Sociologists have found that individuals in this region tend to place a higher value on perseverance and thrift—values that are oriented toward the future rather than the present or the past—than individuals living in the West.¹⁵⁵ This future-oriented perspective, unsurprisingly, is reflected in government. For example, in 2008, the South Korean government retained McKinsey & Company to

149. NOW FOR THE LONG TERM, *supra* note 127, at 58.

150. *Id.*; see also Guy Peters & John Pierre, *Governance Without Government? Rethinking Public Administration*, 8 J. PUB. ADMIN. RES. & THEORY 223, 231 (1998).

151. Political oversight would also serve the goals of ensuring that the agency does not become a victim of regulatory capture, ensuring that the agency continues to have sufficient powers to carry out the long-term goals defined by political institutions (i.e., that they have not been weakened by new circumstances that raise issues that fall outside the agency’s mandate or by overly intrusive judicial review), and taking legislative action to resolve any problems that arise.

152. See Cristie L. Ford, *Principles-Based Securities Regulation in the Wake of the Global Financial Crisis*, 55 McGill L.J. 257, 298–99 (2010).

153. See FRANK PARTNOY, *WAIT: THE ART AND SCIENCE OF DELAY* (2012) (which provides a host of insightful and entertaining examples of how slowing down responses leads to better decision making).

154. See GEERT H. HOFSTEDE, *CULTURE’S CONSEQUENCES: COMPARING VALUES, BEHAVIORS, INSTITUTIONS, AND ORGANIZATIONS ACROSS NATIONS* 351–72 (2d ed. 2001); Geert Hofstede & Michael Harris, *The Confucius Connection: From Cultural Roots to Economic Growth*, *ORG. DYNAMICS*, Spring 1988, at 5, 16–17.

155. See *supra* note 154.

develop a study on the challenges and opportunities it will likely face through to 2020.¹⁵⁶ There is room to explore ways to use political systems to overcome (and perhaps gradually change) short-term biases that seem at present to be ingrained in Western culture.

There may also be merit in exploring the use of existing legal instruments. For example, a public express trust is a charitable trust established to further a specific public goal or to help the community in general.¹⁵⁷ One can easily imagine concepts such as the gradual transfer of a significant minority ownership interest in private institutions to such a public trust with a future-oriented remit (much like the focus of many sovereign wealth funds today).¹⁵⁸ Thinking through appropriate governance frameworks for such public trusts, as well as for their voice in private institutions, might be instructive in itself.

D. RETHINKING REGULATION

It is remarkable that notwithstanding (perhaps, in part because of) the flurry of regulation in the five years after the “global financial crisis” scant attention has been paid to some of the “big questions.” What are the characteristics of effective financial services and regulation? Are complex financial products beneficial? Is a complex financial system with larger institutions beneficial? How does (and how should) our financial system add value? How can regulators better identify and respond to emerging risks?

We noted earlier the hazards of regulatory frameworks. Instead of responding to questions such as those above in a thoughtful way, most regulators have been mired in a backward-looking, highly politicized adversarial process. Likewise, rather than thinking about ways to innovate and develop, many financial institutions are focused on defending their incumbency—from regulatory intervention or in court. The result is a vicious cycle—complex rules breed complex systems and an “is it legal” approach to product design and institutional cultures that can put consumers at risk. A preoccupation with process and controls can often distract from focusing on innovation and the creation of sustainable value. It can also promote regulatory tunnel vision rather than anticipating and tackling issues before they become significant social concerns. To take a few simple examples, insufficient attention has been paid to the rapid growth of the asset management industry and the systemic risks posed by its shifting composition. This shift to passive strategies has increased the potential for herding and correlated market movements. The shift to illiquid funds creates market risk. The shift of market risk from intermediaries to end investors and the process of de-equitization

156. Barton & Wiseman, *supra* note 61, at 3.

157. See *Comm’rs for Special Purposes of the Income Tax v. Pempel*, [1891] A.C. 531, 580–83 (Eng.); *Bob Jones Univ. v. United States*, 461 U.S. 574, 589 (1983); *Vancouver Soc’y of Immigrant & Visible Minority Women v. M.N.R.*, [1999] 1 S.C.R. 10, ¶¶ 32–33 (Can.).

158. See BENJAMIN J. RICHARDSON, *FIDUCIARY LAW AND RESPONSIBLE INVESTING: IN NATURE’S TRUST* 227 (2013).

and of institutional investors seeking to de-risk their portfolios appears to be favoring restless capital just when our economy requires patience.¹⁵⁹

One of the questions posed in the years following the 2008 financial crisis was how the system permitted the “culture” of financial services to decline on the scale it did. There was the recognition of the need to refocus on core expectations, rather than detailed policies and procedures. For example, the U.S. Federal Reserve recently issued a statement of bank capital planning that stipulated the need for “economically intuitive” criteria by which directors and management are to judge actions throughout a firm and for which they will be held accountable.

As suggested above, one key is to focus on emerging risks, particularly for those most vulnerable, rather than simply respond to past failures. “Big data” promises to make available to regulators a wealth of searchable data, updated in real time, that could be used to identify emerging problems before a crisis strikes. Big data has already been proven to be effective in detecting emerging problems in other fields—for example, a number of studies show that trends in web searches can be used to detect outbreaks of influenza and other diseases in real time.¹⁶⁰ At least one study indicates that big data could be used to detect problems in the financial sector: a recent analysis carried out using Google Ngram, which charts the annual count of selected letter combinations, words, and phrases appearing in books that have been digitized by Google, found that mentions of “subprime lending” and “credit default swaps” became significantly more frequent between 2003 and 2005—three years before the financial crisis of 2008.¹⁶¹ Had regulators picked up on this “social trend” (i.e., the upswing in mentions of this activity), they might have had an opportunity to examine and start to address these issues before they came to a head.

While we wait for big data to develop, a number of emerging problems—and opportunities—leap out for scrutiny, including those related to emerging payment technologies, retirement investment products, the use of social media, and peer-to-peer financing. Each of these issues, and others, requires deep thought about the business models of firms and their impacts on consumer expectations and behavior.

Another priority should be to take advantage of growing knowledge about effective regulatory instruments. For example, behavioral economics suggests that traditional disclosure requirements are ineffective.¹⁶² There is also a growing recognition of the need for consistent regulation—both geographically and functionally.

159. See Edward J. Waitzer, *OSC Losing the Puck*, NAT'L POST, June 4, 2014, at FP9.

160. See, e.g., Herman Anthony Carneiro & Eleftherios Mylonakis, *Google Trends: A Web-Based Tool for Real-Time Surveillance of Disease Outbreaks*, 49 CLINICAL INFECTIOUS DISEASE 1557 (2009); Jeremy Ginsburg et al., *Detecting Influenza Epidemics Using Search Engine Query Data*, 457 NATURE 1012 (2009).

161. Joshua Mitts, *Predictive Regulation* (Mar. 14, 2014) (unpublished manuscript available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2411816).

162. See Sah, Lowenstein & Cain, *supra* note 4, at 301–02; Cain, Lowenstein & Moore, *supra* note 78, at 19–21.

Private sector leadership, through collaborative self-regulation, may help to accelerate solutions.¹⁶³

The U.S. Office of Financial Research, established under the Dodd-Frank Act to “improve the quality of financial data available to policymakers and to facilitate more robust and sophisticated analysis of the financial system,”¹⁶⁴ may prove a useful mechanism for promoting a more holistic, forward-looking, and effective regulatory paradigm. So, too, will our courts, we predict, as they fill gaps in redefining the roles and responsibilities of agents and fiduciaries.¹⁶⁵

Models for “soft law”—consensual norms that reflect “reasonable expectations” migrating into enforceable legal standards are rapidly evolving.¹⁶⁶ Notable examples are the UN Guiding Principles on Business and Human Rights (“Guiding Principles”)¹⁶⁷ and the OECD Guidelines for Multinational Enterprises.¹⁶⁸ The Office of the UN High Commissioner for Human Rights recently confirmed that the Guiding Principles apply to financial institutions, and that they give rise to a responsibility to conduct risk-based human rights due diligence (i.e., to assess the risk that engaging or investing in a project will implicate a company in human rights violations) and for such institutions to use their influence to mitigate human rights harm with which investee entities are directly linked.¹⁶⁹

163. For example, the Investment Industry Regulatory Organization of Canada, the self-regulatory organization that oversees investment dealers and trading activity on debt and equity marketplaces in Canada, recently developed a Code of Conduct in relation to the Canadian Dollar Offered Rate (CDOR) benchmark, set through self-reporting by Canadian financial institutions and used as a reference rate for futures contracts, forward rate agreements, and swaps. The Code of Conduct sets minimum standards for banks’ submission methodologies, internal oversight, and record retention. An administrator will be appointed to oversee the scheme. See Press Release, Inv. Indus. Regulatory Org. of Can., IIROC Publishes New Industry-Developed Code of Conduct for CDOR Submission (June 2, 2014), available at <http://goo.gl/oJDXLl>. Another promising initiative has emerged in the United Kingdom, where Britain’s largest banks and building society commissioned a report setting out plans to establish a Banking Standards Review Council, which would be tasked with “promot[ing] high standards in U.K. banking.” See RICHARD LAMBERT, BANKING STANDARDS REVIEW 2–4 (2014), available at <http://www.bankingstandardsreview.org.uk/assets/docs/may2014report.pdf>.

164. *About the OFR*, U.S. DEP’T TREASURY, <http://www.treasury.gov/initiatives/ofr/about/Pages/default.aspx> (last visited July 15, 2014).

165. See TAMAR FRANKEL, FIDUCIARY LAW 285–87 (2011) (who similarly predicts that courts will use fiduciary law to impose constraints on powerful private actors); Henry E. Smith, *Why Fiduciary Law Is Equitable*, in PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW (Andrew S. Gold & Paul B. Miller eds., forthcoming 2014), available at <http://goo.gl/K7gqIJ> (noting that fiduciary law’s traditional role has been to fill gaps left by other areas of the law, particularly where it appears that these gaps are being exploited by opportunistic actors).

166. See Ryan Goodman & Derek Jinks, *How to Influence States: Socialization and International Human Rights Law*, 51 DUKE L.J. 621, 638–56 (2004); Geoffrey Palmer, *New Ways to Make Environmental Law*, 86 AM. J. INT’L L. 259, 269 (1992); Kal Raustiala, *Transgovernmental Networks and the Future of International Law*, 43 VA. J. INT’L L. (2002).

167. U.N. HIGH COMM’R FOR HUMAN RIGHTS, GUIDING PRINCIPLES ON BUSINESS AND HUMAN RIGHTS (2011), available at http://www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf.

168. ORG. FOR ECON. CO-OPERATION & DEV., GUIDELINES FOR MULTINATIONAL ENTERPRISES (2011), available at <http://www.oecd.org/daf/inv/mne/48004323.pdf>.

169. Letter from Craig Mokhiber, Chief, Dev. & Econ. & Social Issues Branch, Officer of the High Comm’r for Human Rights, to Joris Oldenziel, Ctr. for Research on Multinational Corps. 6 (Apr. 26, 2013), available at <http://goo.gl/opBSv2>. This position was also articulated formally to the OECD Working Party on Responsible Business Conduct in respect of a specific complaint brought against the Norwegian government pension fund and a Dutch pension fund (APG), which argued that

Initiatives similar to these with respect to human rights are now being launched to develop consensual norms for sustainable financial systems. For example, the United Nations Environment Programme (UNEP) launched such an inquiry in January 2014, aiming to identify and link a growing number of complementary initiatives in “green” and sustainable finance.¹⁷⁰ In the same month, the Chinese Development Research Center of the State Council released an initial exploration on Greening China’s Financial System.¹⁷¹ The leadership of emerging nations in such an enterprise is particularly promising, to the extent it reflects or facilitates their engagement on these issues.

Another illustrative example is the “conflict minerals” disclosure mandate in the Dodd-Frank Act which required the U.S. Securities and Exchange Commission to include requirements for disclosures relating to conflict minerals originating in the Democratic Republic of the Congo.¹⁷² The Court of Appeals for the D.C. Circuit recently ruled that requiring conflict minerals disclosure violated the First Amendment’s prohibition against “compelled speech” on the basis that the rule was not even reasonably related to the SEC’s mission of “preventing consumer deception.”¹⁷³ The lengthy and highly contested rulemaking process and judicial review thereof highlight the risks of soft principles migrating into hard law in a non-collaborative manner.

E. RE-ASSERTING THE SOCIAL UTILITY OF FINANCIAL SERVICES

It is generally acknowledged that there is a pressing need to re-assert and promote public awareness of the social utility of the financial sector and markets. Public perceptions of the sector are dominated by lack of understanding or trust.¹⁷⁴ While the sector continues to enjoy heavy public subsidies,¹⁷⁵ it is perceived to have massively misallocated capital and generated sub-optimal social returns. The cultures of financial institutions have become harder to manage and isolated from the values and beliefs of the “millennial generation.”¹⁷⁶ On the other side of

both should be viewed as multinational enterprises and thereby be required to conduct human rights due diligence. Letter from Francesca Marotta, Officer-in-Charge, Dev. & Econ. & Social Issues Branch, Officer of the High Comm’r for Human Rights, to Roel Nieuwenkamp, Chair, Working Party for Responsible Bus. Conduct, Org. for Econ. Co-operation & Dev. ¶¶ 4, 15, 20–28 (Nov. 27, 2013), available at <http://www.ohchr.org/Documents/Issues/Business/LetterOECD.pdf>. For an interesting discussion of risk-based human rights due diligence, see INST. FOR HUMAN RIGHTS & BUS., STRIVING FOR EXCELLENCE: MEGA-SPORTING EVENTS AND HUMAN RIGHTS (2013), available at <http://goo.gl/V0NLuT>.

170. UNITED NATIONS ENV’T PROGRAMME, INQUIRY INTO THE DESIGN OF A SUSTAINABLE FINANCIAL SYSTEM: POLICY INNOVATIONS FOR A GREEN ECONOMY (2014), available at <http://www.unep.org/greeneconomy/financialinquiry/>.

171. SIMON ZADEK & ZHANG CHENGHUI, GREENING CHINA’S FINANCIAL SYSTEM: AN INITIAL EXPLORATION (2014), available at <http://goo.gl/7v87gN>.

172. Conflict Minerals, Exchange Act Release No. 67716, 2012 WL 3611799 (Aug. 22, 2012).

173. Nat’l Ass’n of Mfrs. v. SEC, 748 F.3d 359, 370–73 (D.C. Cir. 2014).

174. See *supra* note 9.

175. It enjoys subsidies in a variety of forms, including access to subsidized funding and regulatory entry barriers.

176. See Morley Winograd & Michel Hais, *How Millennials Could Upend Wall Street and Corporate America* (Brookings Inst. Governance Studies, May 28, 2014), available at <http://goo.gl/Tr4fgu>.

the coin, there are extraordinary opportunities for the sector to develop (and better explain) products, services, and markets that help mobilize capital and allocate risk to address pressing social needs. Consider, for example, work underway on new environmental,¹⁷⁷ longevity,¹⁷⁸ or social enterprise¹⁷⁹ asset classes.

Accelerating this process presents a chance for the financial sector, working in collaboration with governments and regulatory bodies, to “connect the dots”—increasing public awareness of the vital role of financial services in mobilizing and allocating capital and risk and creating sustainable wealth.

Likewise, such leadership by financial sector regulators and policy makers best demonstrates that financial regulation is about more than protecting consumers from deceptive products and practices. Rather, it should be to ensure, more broadly, that society is well served and that consumers get a “fair deal.” This should lead to the articulation of public stewardship responsibilities throughout the financial services supply chain.

CONCLUSION

The financial services sector can be an essential force for good. Realizing this possibility, however, will require deliberate action to correct the cultural and structural problems that have persisted within this sector. The need for such action is both clear and widely acknowledged. It is difficult to think of a sector that has experienced more trust destruction in recent years than financial services.¹⁸⁰ In a recent survey of financial services professionals, carried out by the CFA Institute, over half (54 percent) of respondents pointed to a lack of ethical culture within financial firms as the factor that has contributed most to this lack of trust (a result consistent with surveys in previous years).¹⁸¹ At the same time, another survey sponsored by the CFA Institute found that financial services executives generally (91 percent) agree that ethical conduct is just as important as financial success at their firms.¹⁸²

Ultimately, these data points will converge and lead to regulatory action and reform. For instance, in the Netherlands, all banking employees will soon be required to take an oath pledging that they will do their “utmost to preserve and enhance confidence in the financial services industry” and put the interests of both clients and society first.¹⁸³ The Netherlands also plans to limit bankers’ bo-

177. RICHARD L. SANDOR, NATHAN CLARK, MURALI KANAKASABAI & RAFAEL L. MARQUES, CFA INST., ENVIRONMENTAL MARKETS: A NEW ASSET CLASS (Jan. 2014), available at <http://goo.gl/svyoMR>.

178. Can. Office of the Superintendent of Fin. Institutions, Longevity Insurance and Longevity Swaps (Policy Advisory No. 2014-002, May 2014), available at <http://www.osfi-bsif.gc.ca/eng/pp-rr/ppa-rra/inv-plc/pages/longinslet.aspx>.

179. Paul Chong & Linda Kleemann, *The Future of Funding for Social Enterprises* 9–11 (Kiel Policy Brief No. 34, Sept. 2011), available at <http://goo.gl/lQYuz8>.

180. See Joseph E. Stiglitz, Op-Ed., *In No One We Trust*, N.Y. TIMES, Dec. 22, 2013, at SR4.

181. CFA INST., *supra* note 11, at 22.

182. *Id.*

183. Maud van Gaal, *Dutch Bankers Swear to God as Trust in Lenders Slumps*, BLOOMBERG (Feb. 6, 2014), <http://goo.gl/is1u99>; see also *Banker’s Oath/Solemn Affirmation of Policymaker*, NIBC BANK, N.V., <http://goo.gl/vfyv5b> (last visited July 15, 2014).

nuses to 20 percent of pay—an even lower cap than the 100 percent cap proposed by the European Union.¹⁸⁴ Surely, the sector itself can craft more effective responses to societal expectations.

Though other jurisdictions have not gone as far as the Netherlands yet, the trajectory of the law is clear. Regulators, legislators, and courts are expanding “fiduciary” duties based on reasonable expectations and, increasingly, are informed by the principle that finance should serve the public interest. Absent industry leadership, politics will likely accelerate this dynamic, with those institutions that are most visible being the most likely to be held to account first.

Viewed broadly, the financial sector has a choice. It can continue to be reactive and seek to maintain an unsustainable status quo, or take a proactive and collaborative approach that is responsive to this rapidly emerging dynamic. The immediate consequences of choosing the first option are already well known—more complex regulation that implies higher compliance costs, higher penalties, lower public confidence, and, ironically, a less effective financial system. The longer term consequences of a failure to be proactive pose even greater environmental and social as well as financial threats.¹⁸⁵

This paper has aimed to sketch out some illustrative elements of what an alternative approach might look like. We have tried to begin to map out how a “fiduciary of the future” might function and how institutions should begin to change their culture to align with this perspective. We have also explored how institutions should collaborate to initiate and achieve systemic change (and share the necessary costs of doing so). Finally, we have considered the role regulators and political institutions can play in supporting the transition to a more sustainable economy, both by establishing new institutions that imbue government with a long-term perspective and by designing regulation so as to more effectively achieve such shared goals.

In his first economic message, Pope Francis noted that “whatever is fragile, like the environment, is defenseless” against markets that are devoid of social purpose and that hence show a “lack of real concern for human beings.”¹⁸⁶ He went on to argue that a financial system imbued with ethical values “would make it possible to bring about balance and a more human social order.”¹⁸⁷ A few months later, at the 2014 World Economic Forum, the Pope further argued that capitalism should be animated by “a renewed, profound and broadened sense of responsibility” to further the common good.¹⁸⁸

As a major financial institution, the Vatican has hardly acquitted itself as a model for others to follow.¹⁸⁹ Yet the Pope’s remarks unquestionably reflect a

184. See *supra* note 183.

185. See WORLD ECON. FORUM, GLOBAL RISKS REPORT 23 (9th ed. 2014).

186. Pope Francis, *Evangelii Gaudium*, VATICAN PRESS, NOV. 24, 2013, ¶¶ 55–56.

187. *Id.* ¶ 57.

188. *Pope Francis’ Message to World Economic Forum in Davos*, OFFICIAL VATICAN NETWORK (Jan. 21, 2014), <http://goo.gl/X7mL8N>; Michael J. de la Merced, *Pope Urges Davos Notables to Remember the Less Fortunate*, N.Y. TIMES DEALBOOK (Jan. 21, 2014, 5:58 PM), <http://goo.gl/bHRXhe>.

189. See Rachel Sanderson, *Scandal at God’s Bank*, FIN. TIMES, Dec. 7, 2013, at 1.

broader current in public opinion, one that is increasingly reflected in the actions of regulators and courts: the understanding that the market system has achieved tremendous successes and continues to have enormous potential to serve the common good, but a belief that this potential can only be achieved so long as the financial sector is guided by a sense of social purpose. This requires a clear understanding of the degree to which it is embedded within, and relies upon, a shared social infrastructure. This may well be the inflection point that our financial sector will either embrace or have imposed upon it.