

# THE THREE GRADES OF PENSION FUND GOVERNANCE QUALITY:

## BAD, BETTER, AND BEST

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In 1976, Peter Drucker wrote “The Unseen Revolution”, a prescient book about the coming flood of retirement savings and the political, economic, and governance challenges it would create. Today, the pension revolution is unseen no longer. The \$25 trillion in accumulated pension assets around the globe has become very visible, especially to the multitude of agents who see these assets as potential sources of power and fee income [1]. This raises important questions:

- Through what legal and governance structures is this immense lump of pension money being managed?
- How can we grade the effectiveness of these structures?
- What principles should guide the design of optimal forms of these structures?

The purpose of this article is to address these questions. We start with a brief look at some recent updates of theories about financial intermediation in general, and institutional investing in particular. Next we review recent research findings about pension fund governance. Then we propose a three-level governance quality taxonomy: bad, better, and best. We finish with some ideas about what it will take to elevate bad governance regimes to better, and better regimes to best.

### Theory Updates

In their 2004 paper “Design of Financial Systems: Towards a Synthesis of Function and Structure”, Robert Merton and Zvi Bodie develop an elegant theory of financial system design by bringing together three related theories of finance: neoclassical, behavioral, and institutional. The focus of the institutional dimension of their design is to address existing agency problems and market frictions. Consistent with this macro financial systems framework, this author recently proposed an extension of micro-based portfolio theory, first formulated by Harry Markowitz in 1952. As set out in “Beyond Portfolio Theory: the Next Frontier” (2005), the purpose of Integrative Investment Theory is to address the same agency problems and market frictions that Merton and Bodie alluded to in their macro framework from a normative perspective.

Integrative Investment Theory (IIT) is defined as follows:

$$\text{Client/Beneficiary Value Creation} = f\{A, G, R, IB, FE\}$$

where:

- A = agency issues
- G = governance structure
- R = risk issues
- I = investment beliefs
- FE = financial engineering/implementation

IIT purposely differentiates between agency issues (A) and the governance structures (G) used to manage financial capital pools. This differentiation is useful in helping disentangle issues related to the legal structures within which institutional assets are held, and the organizational structures through which the assets are managed. We will show below that the distinction is especially important in pensions contexts, where, in our view, the Anglo-Saxon legal trust framework has created agency problems that have been, and continue to be a serious barrier to the development of effective, functional pension fund governance structures. While the remaining three elements of IIT (i.e., R, IB, and FE) were already incorporated in the initial formulation of portfolio theory, they are updated to better fit current institutional realities. Risk issues are far more complex than the specification return distribution variances. Investment beliefs are far more complex than the statement of return expectations. Financial engineering has become a far more complex set of techniques and procedures than the simple calculation of an efficient frontier.

### **An Emerging Research Literature**

After some barren decades, there is now an emerging research literature on pension fund governance and its impact on organization performance. For example:

1. Anthropologists O’Barr and Conley caused a stir with their 1992 book *Fortune and Folly: The Wealth & Power of Institutional Investing*. Based on observing behavior at nine major U.S. pension funds over a two year period, they concluded that the aim of pension fund governance appeared to be focused more on responsibility deflection, blame management, and fostering cozy relations with service suppliers, than on good governance and creating value for fund stakeholders.
2. Ambachtsheer, Boice, Ezra, and McLaughlin designed a survey that was answered by 50 senior pension fund executives in December 1994 during a symposium titled “Excellence in Pension Fund Management: What Is It?” Asked to estimate the ‘excellence shortfall’ in their organizations, the median response was a material 66 basis points. Asked to identify the sources of excellence shortfall, the three causes mentioned most frequently were poor decision processes, inadequate resources, and lack of focus or mission clarity.
3. Ambachtsheer, Capelle, and Scheibelhut conducted a survey-based study of the governance practices of 80 pension funds in 1997 using a North American database. They found a positive correlation between proxy metrics for pension fund governance quality and for pension fund performance. High-quality funds outperformed low-quality funds by about 1% per annum. They also identified a number of specific fund oversight and management factors as important performance drivers. A serious board competency issue was uncovered (e.g., haphazard trustee selection processes, no trustee self-evaluation processes, lack of delegation clarity between the board and management, board micro-management).
4. Clark, Caerlewy-Smith, and Marshall studied the problem-solving capabilities of pension fund trustees in 2006 in the U.K. and found these capabilities “surprisingly heterogeneous”, with potentially material negative implications for pension fund governance quality.

5. Ambachtsheer, Capelle, and Lum conducted a follow-up study in 2006 to the 1997 study summarized above using survey results and a database encompassing 81 European, North American, and Pacific Rim pension funds. The findings of this new study were very similar to those of the 1997 study. Once again, there was a positive correlation between proxy metrics for pension fund governance quality and for pension fund performance. High-quality funds outperformed low-quality funds by about 2% per annum. The board competency issues identified in 1997 continued to be problematical nine years later. The consequences included board difficulties in sorting out the competing interests embedded in many pension arrangements, and non-competitive compensation structures inside many pension funds.
6. Clapman et al. (2007) noted “a series of disconcerting failures in the governance of pension funds”, and recommended a list of ‘best practices’ governance principles to address these failures. The principles are organized into five areas: (1) transparency, (2) leadership, (3) core competencies, (4) conflicts of interest and disclosure, (5) delegation.

The bottom line of these research findings is that even today, at \$25 trillion, the challenge for many pension funds around the world continues to be to raise their governance game from bad to better, and that bad governance practices have an economic cost. This somber conclusion is reinforced by the fact that the research findings summarized above were based largely on data and information obtained through the willing cooperation of a few hundred positively-motivated pension fund governors and senior executives in a series of surveys and experiments. If anything, this positive selection bias may be placing the cited research findings in a too optimistic light.

### **Why So Little Progress?**

This author has been advocating the adoption of a ‘high performance’ vision for pension fund governance for quite some time now [2]. This ‘high performance’ vision involves, among other things, the careful assembly of a professional board of governors, significant board delegation to internal expert management, and internal compensation schemes that allow pension funds to compete for top talent. This functional perspective was publicly attacked recently by a prominent ERISA attorney in the USA, arguing that pension trustees are subject to trust law and thus have individual responsibilities, and only limited scope for delegation [3]. Under this legal interpretation, trustees cannot conduct themselves as the governors of ‘high performance’ pension delivery organizations. The importance of this prevailing legal perspective cannot be underestimated, as it continues to dictate the structure and performance of the governance of many pension funds in the Anglo-Saxon countries, especially in the UK and the USA. The operational implications of this legal perspective of governance contrast sharply with those flowing from the functional ‘high performance’ perspective.

The legal perspective of pension fund governance is based on the carry-forward of the conventions of traditional Anglo-Saxon trust law. Trusts were originally legal mechanisms established to maintain English estates for the benefit of successive family generations and other beneficiaries. The trust concept evolved over time, an important element being the institutionalization of wealth management away from purely land and real estate, into other productive areas of commerce such as manufacturing and merchandizing. This evolutionary process was aided considerably by the standardization of such financial instruments as bonds and stocks. But who were the trustees who assumed personal responsibility for governing these trust

arrangements? Often they were relatives of the aristocratic land owners who created the original trusts. For example, in the famous case of *Harvard College vs. Amory* some family members were entrusted to manage an estate on behalf of the surviving widow and children, with the residual beneficiary of the estate being Harvard College. When the trustees reduced the value of the estate through poor investments, Harvard sued, arguing that the trustees had an obligation to maintain the original value of the estate. The court found in favor of the trustees, deciding that they had acted in good faith and could not be held legally liable for making investment decisions that turned out poorly.

So what should trustees not professionally equipped to make difficult legal, financial, and investment decisions in the best interests of others do? Well, they don't want to make legal mistakes...and they don't want to make financial or investment mistakes. So logically, the prudent thing to do is to solicit professional expert advice about these matters. Fast-forwarding the traditional trust model and its prudence standard into the pension fund context of today, that professional expert advice should logically include legal advice (i.e., 'how should we behave?'), financial advice (i.e., how should we fund our liabilities?) and investment advice (i.e., how should we invest our assets?). And that indeed is the governance model many pension funds in the Anglo-Saxon countries continue to cling to today: well-meaning groups of lay-people (i.e., the trustees) surrounded by a coterie of powerful 'experts' advising them how to behave and make decisions on a broad array of legal, financial, and investment matters. This is a dysfunctional 'manage from the outside in' governance model. Its design makes it unresponsive to changing plan participant needs and circumstances, and from an agency perspective, is likely to work better for the outside 'experts' than for the people it is meant to serve.

### **A Functional Governance Model**

The functional approach to designing a pension fund governance structure has more recent origins. In their 1932 treatise "The Modern Corporation and Private Property" Adolf Berle and Gardiner Means warned that when organization ownership and control are separated, the specter of 'agency costs' looms large. Their specific focus was American capitalism without owner-operators such as the Carnegies, Fords, Mellons, and Rockefellers. What would prevent these 'agents', they asked, as corporate control moved out of the hands of these giants and into the hands of faceless professional managers, from managing Corporate America in their own interests, rather than those of the shareholders? A profound question still being debated to this day.

Twenty years after Berle and Means, Vanguard founder Jack Bogle would add an interesting twist to the agency costs issue. He warned that if shareholders were even further separated from corporate control through the existence of a 'for profit' mutual fund sector, the ultimate owners of Corporate America would be subjected to yet another layer of agency costs. Not only would they incur agency costs at the corporate level, but now also at the investment management level. Will market discipline and transparency not take care of this agency cost problem? The economist George Akerlof would win a Nobel Prize in 2001 for explaining why this is not necessarily the case: 'informational asymmetry'. Markets can only provide proper prices and costs if there are many buyers and sellers, making decisions from the same product information/understanding base. There is overwhelming evidence that the retail market for investment management services does not meet these conditions [4].

Addressing these agency issues gets us only part way to designing pension fund governance structures responsive to stakeholder needs. Deep thinkers on management and organization design issues such as Peter Drucker, Elliott Jaques, and John Carver taught us decades ago that governance issues are equally important, and we ignore them at our peril. The essence of their message is that organizations cannot function on good intentions alone. A conscious effort is required to sort out matters such as:

- The purpose of the organization.
- The role of the oversight board and its accountability to the organization's members/stakeholders/owners.
- The need for clarity about what the board does (e.g., defines, delegates, and monitors), and does not do (e.g., performs operational tasks).
- The need of the board to act as a collective body, speaking with one voice to define its expectations, assigning these expectations to a chief executive chosen by the board, and then checking that they are met.
- The role of management as the initiator, and with board approval, the implementer of strategic and operational plans required for the organization to achieve the board's expectations. HR and IT will be critical components of such plans.

The overriding message here is that effective governance is critical to organization success, and that a strong, competent oversight board is the heart of an effective governance structure. Further, to be both strong and competent, an oversight board must pass two tests:

- **Board member motivation**: board members must understand why the organization exists and be able and willing to dedicate their time, wisdom, skills, and experience to helping the organization achieve its purpose. Whether compensated or not, the primary motivation of board members must be public service, and not fame, fortune, or other personal predilections (e.g., box seats, fancy trips, political profile). Placing this requirement specifically in a pension fund governance context, board members must be able and willing to understand the nature of the pension 'deal' and to play a dedicated, constructive oversight role in ensuring that it is implemented as intended, in a cost-effective manner.
- **Board member competence**: proper board member motivation is not enough. The capacity to think strategically, combined with relevant skill/experience sets (e.g., investments, risk management, strategic planning, audit and accounting, HR) is equally important. Possibly more clearly than anyone else, Elliott Jaques laid out the necessary connection between work complexity and mental processing capacity. This connection applies equally to oversight and operational positions. The work of oversight boards of financial institutions such as pension delivery organizations involves significant complexity. Thus this reality must be integrated into how board members are selected [5].

The critical conclusion to be drawn from all this is that the legal and functional approaches to structuring pension fund governance lead to very different outcomes. Close adherence to traditional, prudence-based trust law principles almost certainly leads to weak governance processes with its attendant economic costs. Following the dictates of modern organization design principles creates a solid foundation for building strong value-producing governance processes in pension funds.

## The Clapman Contribution: from Bad to Better

The *Wall Street Journal* recently featured an article titled “Group Turns Governance Spotlight on Pension Plans”. It reported that the Stanford Institutional Investors’ Forum was about to release a set of governance-related recommendations crafted by a committee chaired by Peter Clapman, former Senior Vice President and Chief Counsel of TIAA-CREF. Commenting on the recommendations, *WSJ* observed that “...some are so elementary they hardly seem worth stating...”. Clapman defended the work of the committee arguing that “a very large percentage of funds are not doing one or more” of the actions the Stanford report recommends. This author agrees with that assessment and believes that, were all of the report’s recommendations (summarized in Appendix I) adopted, many funds would indeed transition from being badly- to better-governed. The Stanford report does, however, suffer from a mislabeling problem through its title: “Best Practice Principles”. In our view, the principles it espouses are not ‘best practice’, but ‘better practice’.

The important point is that while moving from ‘bad practice’ to ‘better practice’ governance regime is a worthy goal, it should not be seen as the end of the governance road. Instead, it should be seen as a way-station to a true ‘best practice’ level of governance and organization design that leads to ‘high-performance’ pension delivery organizations (PDOs) capable of producing superior investment and ‘client’ service results over extended periods of time. The Clapman Committee does not seem to be aware of the distinction between ‘better’ and ‘best’. They write that their report resulted from Forum discussions and from the insights developed through the individual professional experiences of the 11 Committee members. While we do not doubt that these experiences were both informative and profound, we also suspect they were limited. For example, there is no evidence that the Committee looked either at ‘best practice’ outside the USA, or at the emerging body of governance research that is helping shape the prototype ‘high-performance’ PDO, and is documenting what it takes to actually create them.

### The ‘High-Performance’ PDO

‘High-performance’ PDOs no longer just exist on drawing boards. Though still only small in number, they also exist in the real world [6]. Four key attributes of these organizations are:

- **Arms-Length Legal Structure:** the PDO must be able to operate independently in either a not-for-profit corporate or foundation-type legal structure, with the single goal of delivering pensions to beneficiaries in a cost-effective manner.
- **Professional Board Structure:** while the ‘representative’ dimension of board of governors composition cannot be ignored, neither can the ‘competence’ dimension. Both dimensions must be tended to if the board is to both have legitimacy and be an effective oversight body.
- **‘High-Performance’ Culture:** this requires a conscious board decision. On the investment side, the acid test is a willingness to pay for properly-defined and measured investment performance at compensation levels that are at least reasonably market-competitive in a highly-paid industry.
- **Sufficient Scale:** pension investing and administration are both highly scalable activities. Bigger is better. Rules of thumb for minimum required scale markers are at least \$10B in assets and/or 50,000 plan members [7].

Why are there still so few PDOs with these four attributes? Because formidable barriers stand in the way of creating them:

- **Legal Barriers:** can be real or imagined. On the real side, if a PDO is structured in a manner where it cannot operate at arms-length from special interest groups (whether government, corporate, or labor), it will have great difficulty setting and meeting 'high performance' standards. On the imagined side, a narrow legal interpretation of the application of trust law will be just as harmful to setting and meeting true excellence standards. Both types of barriers can impede a PDO's effectiveness in designing and delivering pension products and services of measurable excellence.
- **Governance Barriers:** the Clapman Committee report covers some of this ground (e.g., the needs for the right collective skill/experience set for Board, for formal trustee selection, education, and evaluation processes, for clear accountabilities and delegation from board to others; see Appendix I for a complete listing). However, the report's language suggests the Committee's ambitions are limited. For example, it states: "Trustees should be permitted to delegate responsibilities, subject to appropriate instruction and oversight, to unconflicted consultants and staff." First, the consultant-staff ordering is indicative. Consultants appear to outrank staff in the minds of the Clapman Committee. Second, 'high performance' organizations don't have 'staff'. Instead, they have CEOs and teams of executives and professionals capable of constructing and implementing strategic plans consistent with the values, vision, and mission of the organization.
- **Competency Barriers:** there is still a perception in many places (especially in the UK and the USA) that PDOs can be managed and operated 'on the cheap'. Ironically, this is a very expensive perception. Logic suggests and research confirms that an unwillingness to pay up for internal PDO talent means highly-compensated external services suppliers end up being paid too much for too little [8]. A case of being pennywise and pound foolish. In contrast, 'high performance' PDOs create market-competitive compensation structures for internal executives and professionals. The pay-back on these compensation 'investments' can be highly material [9].
- **Scale Barriers:** we have already noted that investing and pension delivery are both highly-scalable activities. Thus scale matters. Any board overseeing a PDO materially smaller than the minimum scale markers of \$10B assets/50K members should put 'merger' high on its list of priorities [10].

Breaking down these barriers will be no easy task. The potential payoff for doing so is enormous.

### **From Bad to Better to Best**

This article presents evidence that many pension funds continue to be saddled with bad governance structures and practices which hamper the efficient conversion of retirement savings into pension payments. The recent Clapman Committee report provides a good roadmap guiding badly-governed pension funds to become better-governed. There is, however, a higher governance quality standard that pension funds can, and should aspire to. Global attainment of truly 'best practice' pension fund governance would directly address the agency issues and institutional frictions that continue to hamper savings-to-pensions conversion processes around the world. That is not all. 'High-performance' pension funds are also motivated to use their

proxy voting power to reduce agency costs in the corporate sector, thus increasing the efficiency of capitalism. Peter Drucker would be pleased.

## NOTES

[1] A recent study by Watson Wyatt Worldwide estimates 2006 pensions assets in the world's top-11 pensions countries to be \$23 trillion.

[2] See, for example, Part Three of *Pension Revolution*.

[3] The occasion was a State Street client conference, and the attorney was Ian Lanoff, legal advisor to some of America's largest pension funds and former Administrator of Pension and Welfare Benefit Programs at the U.S. Department of Labor.

[4] For example, the 2007 working paper on agency costs by Bauer et al. reports a 2-4% gap between the average net returns of pension fund-managed and mutual fund-managed domestic equity portfolios in the USA and Canada. They attribute the return gap (in favor of pension funds) to agency and information asymmetry factors.

[5] See *Requisite Organization* for an elaboration of these ideas. Drucker referred to Jaques' work as early as 1976 in *The Unseen Revolution*.

[6] The best examples of real-world 'high-performance' pension delivery organizations are to be found in Australia, Canada, New Zealand, and Northern Europe. The best 'high performance' fund examples in the USA are in the endowment field (e.g., Harvard and Yale).

[7] Scale reduces a pension delivery organization's unit costs in both its investment and pension administration 'businesses'. Most importantly, scale makes the acquisition of internal expertise affordable (e.g., a \$10 million internal expertise budget represents 1%, 0.1%, and 0.01% of the assets of a \$1B, a \$10B, and a \$100B pension fund, respectively).

[8] The 2007 working paper on pension fund governance by Ambachtsheer et al. reported that pension funds with high governance quality scores had higher average net excess returns than low-scoring funds. High-scoring funds also spent more money (scale-adjusted) on the internal oversight and executive functions. All results were statistically significant.

[9] See, for example, the presentation of Bertram and Zvan of Ontario Teachers' Pension Plan (OTPP) to the October 2006 Forum of the Rotman International Centre for Pension Management (ICPM) at the University of Toronto.

[10] We are not aware of any concerted efforts by boards of governors of 'too small' pension delivery organizations to achieve scale through merging with larger entities. The pension regulator in the Netherlands is actively encouraging this type of efficiency-motivated merger among Dutch pension funds.

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Working Paper

## APPENDIX I

### A SUMMARY OF CLAPMAN COMMITTEE FUND GOVERNANCE PRINCIPLES\*

#### Transparency

- *A fund should clearly define and make publicly available its governance rules.*

#### Leadership

- *A fund should identify and disclose its leadership structure and all persons in positions of senior responsibility.*
- *A governing body should consist of appropriately qualified, experienced individuals dedicated to fulfilling their fiduciary duties to fund beneficiaries.*
- *A governing body should promote policies that strengthen fiduciary principles in the selection and monitoring of trustees, and that enable trustees to fulfill their fiduciary responsibilities.*
- *Where trustees are elected to a board to represent a class of fund beneficiaries, the elected trustee should take reasonable steps to acquire the skills to serve appropriately as a fiduciary.*
- *A fund should establish clear lines of authority between its governing body and its staff that reflects a commitment to representing beneficiary interests. Delegations of authority should be clearly defined and regularly reviewed.*
- *A governing body should have authority to select and dismiss key staff and independent advisors and counsel. Standards of performance should be clearly set, measured, with the results communicated.*

#### Attributes and Core Competencies

- *Each trustee should have a thorough understanding of the fund's obligations to its beneficiaries, the fund's economic position and strategy, and its relevant governing principles.*
- *Each trustee should contribute to a balanced set of skills that enables the board, acting as collective body, to execute successfully its obligations.*
- *The board should at all times include individuals with investment and financial market expertise and experience relevant to the fund's ability to exercise its fiduciary obligations to its beneficiaries.*
- *Trustees, on a regular basis, should obtain education that provides and improves core competencies, and that assists them in remaining current with regard to their evolving obligations as fiduciaries.*
- *The fund should engage in an annual evaluation of trustee skills and, where appropriate, should develop a plan for improving and expanding the board's competencies.*

#### Conflicts of Interest and Disclosure

- *A fund should establish and publicly disclose its policy for dealing effectively and openly with situations that raise either an actual conflict of interest or the potential for the appearance of a conflict.*
- *A fund should establish a regular, automatic process that requires all covered persons to report actual or potential conflicts of interest.*
- *Trustees and staff should periodically affirm and verify compliance with all conflict rules.*

- *Trustees and staff should under no circumstances pressure anyone to engage in a transaction that creates an actual conflict or an appearance of one.*
- *A fund should publicly disclose necessary information in relation to actual or potential conflicts to ensure that trustees and staff are fulfilling their fiduciary duties to beneficiaries.*

#### Delegation

- *A governing body should be permitted to rely on the expertise and advice of appropriately selected and unconflicted consultants and staff, and be permitted to delegate responsibilities, subject to appropriate oversight, to them.*
- *A fund should require that any consultant or staff from whom material advice is requested or received, or to whom material responsibility is delegated, comply with the fund's conflict of interest and ethics policies.*
- *A fund should institute an evaluation process to assess fund expenditures and weigh the benefits to fund beneficiaries generated by those expenditures against the cost and quality of the service for which funds are expended.*

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\* From Clapman, "Best Practice Principles", Committee on Fund Governance, The Stanford Institutional Investors' Forum, with minor editing changes.