

Protecting Our Best Interests

Rediscovering Fiduciary Obligation



FairPensions

FairPensions (Fairshare Educational Foundation) is a registered charity established to promote responsible investment practices by pension providers and fund managers. FairPensions champions greater transparency and accountability to the millions of people whose long-term savings are managed by institutional investors and other professional agents.

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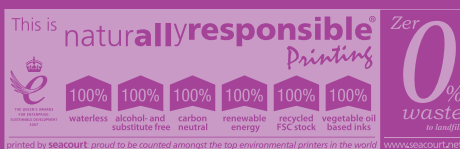
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Executive Summary

In a world where millions depend heavily for their future wellbeing on a small number of people who look after their pension savings and other investments, the behaviour of those people matters deeply. This project set out to explore whether investors' fiduciary duties to the people whose money they manage are fit for purpose in the twenty-first century, particularly in light of the financial crisis. We conclude that the prevailing understanding of fiduciary obligation has lost its way, and that there is an urgent need to rediscover the essence of this valuable concept to ensure savers are properly protected by it.

Fiduciary obligation rediscovered

Fiduciary obligation is about ensuring that those entrusted to act on behalf of others do so reasonably and responsibly, and do not abuse their position for their own ends. But, in an investment context, this core protective purpose often seems to have been forgotten, replaced by the myth of a single, monolithic 'fiduciary duty to maximise returns'. In fact, investors have a number of distinct fiduciary *duties*, the two most fundamental being:

the duty of loyalty - fiduciaries must act in good faith in the interests of their beneficiaries, avoid conflicts of interest and not act for the benefit of themselves or a third party; this also includes a duty to act impartially between different classes of beneficiary;

the duty of prudence - fiduciaries must act with due care, skill and diligence, investing as an 'ordinary prudent man' would do; today this includes a duty to maintain an adequately diversified portfolio.

Prevailing interpretations of fiduciary duty have tended to subsume the duty of

loyalty into the duty of prudence, leading to a neglect of the need to avoid conflicts of interest - particularly as regards the chain of investment agents who make key decisions on behalf of trustees. Moreover, the duty of prudence itself may not be serving the best interests of beneficiaries: the 'ordinary prudent man' standard is in danger of becoming a 'duty to herd', leading to an unhelpful focus on short-term, benchmark-relevant strategies and making the industry slow to adapt. In addition, just as fiduciary obligation evolved in the twentieth century to take account of modern portfolio theory, so it may need to evolve in the twenty-first to take account of wider factors affecting outcomes for beneficiaries, such as systemic and extra-financial risks.

The new fiduciaries

It is not just our understanding of *what* fiduciary obligation is that needs to change, but also our understanding of *who* is a fiduciary. Pension scheme trustees are acutely aware of their strict fiduciary duties - but what of the asset managers and investment consultants to whom they increasingly delegate crucial decisions? And what about the millions of people whose pension savings are based on a contract with an insurance company, a structure in which there are no trustees at all?

Asset managers frequently refer to themselves as fiduciaries, and it is our belief that this does reflect the underlying legal position. But this often seems to be simply a byword for a duty of care towards clients, which applies to all commercial actors, rather than a true appreciation of the much stricter standard of loyalty to which fiduciaries are held. Certainly, if the role of a fiduciary is to put the interests of their beneficiaries above their own, the sharply divergent fortunes of savers and their intermediaries seen in recent years should give cause to question whether fiduciary standards of care are really being achieved in practice.

Unlike asset managers, UK investment consultants do not generally appear to see themselves as fiduciaries - although they are accepted as such in the United States. Given the enormous influence consultants exercise over the decisions of many trustees, we believe that asset managers are indeed fiduciaries under the common law.

We suggest that the regulator should clarify the legal responsibilities of both asset managers and investment consultants towards clients and their beneficiaries. In particular, intermediaries should be reminded that fiduciary obligation includes a duty to avoid conflicts of interest, and, where this is not possible, to manage them effectively. If this is deemed to be impossible under current business models, there is a need to countenance the possibility that it is the business models and not the fiduciary duties which must be changed.

With the shift from trust-based to contract-based pension arrangements, an increasing volume of savings are passing out of the fiduciary sphere altogether. Little consideration has been given to the legal duties owed by insurance companies to their policyholders, or to the potential accountability gap that arises with the absence of trustees. The legal and regulatory framework applying to trust- and contract-based pension providers is uneven. There is an urgent need to review this situation to ensure that pension savers receive the same level of protection regardless of the form of their pension arrangements.

Incentivising responsibility

But it is not enough simply to extend the fiduciary label to a new set of actors and assume that this will protect their beneficiaries. As indicated above, our understanding of fiduciary obligation itself may need to evolve to keep pace with the new challenges facing fiduciary investors.

This is particularly true when it comes to responsible and sustainable investment approaches: historically, fiduciary obligation has more often been interpreted as a barrier to such approaches than a catalyst for them.

In recent years, this has begun to change, with increasing acceptance that serving beneficiaries' best interests requires the consideration of environmental, social and governance (ESG) issues with the potential to affect *financial* returns. But this acceptance is not yet fully reflected in mainstream investment practice. We conclude that one of the key barriers is an absence of incentives: there is a mismatch between the long-term benefits of better ESG risk management and the shorter-term performance benchmarks against which most asset managers are assessed.

Continued confusion over the nature of fiduciary duties may also be holding responsible investment back. Survey evidence suggests a tendency for actors at all stages of the investment chain to see ESG integration as 'somebody else's problem', with a lack of clarity over where the trustees' responsibilities end and those of their agents begin. This is perhaps connected to a lingering perception of ESG as a client-driven ethical preference rather than a truly integral part of financial analysis.

It is also notable that fiduciary obligation is invoked disproportionately to justify neglect of ESG issues, but neglect of ESG issues rarely gives rise to accusations of breach of fiduciary duties. After the Deepwater Horizon oil spill led BP to cancel its dividend for the first time since the Second World War, nobody suggested that trustees might be exposed for having failed to scrutinise the company's risk management. The growing momentum behind responsible investment in some parts of the industry presents an important opportunity for positive change in this area.

Beyond financial interests

The debate over responsible investment raises a further question: can fiduciaries act on environmental and social issues only when they are material to financial returns? Pension fund members who enquire about an ethical issue often encounter the seeming paradox of being told that their views must be ignored because of the trustees' fiduciary duty to act in their best interests. But are trustees legally restricted to interpreting this duty only in terms of financial best interests?

A close reading of case law - particularly the landmark case of *Cowan v Scargill*, which has cast a long shadow over the idea of 'ethical investment' - does not support the idea that non-financial interests are automatically off-limits for trustees. Indeed, the judge in *Cowan v Scargill* explicitly confirmed that non-financial benefits might, under some circumstances, be a legitimate consideration. In this context it is important to remember that fiduciary obligation is not about ensuring trustees make a 'correct' decision based solely on mathematical calculations of risk and return; rather, it is about ensuring their decision-making process is sound, reasonable and motivated by the beneficiaries' best interests.

We conclude that a prudent ethical investment policy, which does not compromise beneficiaries' financial interests and is firmly rooted in their own ethical views, ought to be possible both legally and in practice. But the legal position remains unclear, and statutory clarification may be needed to restore common sense to the law and resolve a debate that has generated more heat than light. We suggest that trustees should be given greater freedom to exercise their judgement, in good faith, on how to serve their beneficiaries' best interests.

Debate around non-financial interests has tended to fixate on ethical issues,

neglecting the question of whether trustees can consider the impact of their decisions on beneficiaries' future quality of life - for example, through social and environmental factors such as climate change. If the purpose of a pension trust is to provide its members with pensions, then what is the purpose of the pension? The obvious answer is 'to provide a decent standard of living in retirement'. This raises the question whether, like charities, pension funds should be free to consider whether their actions are undermining this underlying purpose.

The key issue that arises here, both legally and practically, is the 'remoteness problem': individual investors may be too small to have a material impact on a given macroeconomic issue. This creates a serious collective action problem if - as with climate change - the optimal outcome for all beneficiaries would be universal action which *could* have a material impact on the problem. Further thought needs to be given to how this problem can be overcome, whether through investor collaboration, legal changes, or some combination of the two.

The member's contribution

Any discussion of what is in beneficiaries' 'best interests' inevitably raises the question of who decides what those best interests are. Historically, the fiduciary relationship has been assumed to be a more or less paternalistic one, where trustees are left to decide what will serve beneficiaries' interests with minimal regard for the views of beneficiaries themselves. But is this still appropriate?

We conclude that pensions are meaningfully different from private trusts in this respect, since the beneficiaries themselves provide the capital to be invested (either through their own contributions or indirectly through employer contributions, which are effectively deferred remuneration).

Moreover, with the shift towards defined contribution (DC) arrangements, they increasingly bear the investment risk. In this context, it is difficult to maintain the argument that they should have no say at all in how their money is managed. Research also suggests that people value communication and consultation, and that such engagement may help overcome the distrust that puts many off from saving into a pension at all. Yet members who contact their pension funds to enquire about an issue or express a view often encounter disinterest or even hostility.

Pension providers should be encouraged to consult and inform their members. This applies to both trust- and contract-based providers: insurance companies should consider ways to improve their outreach and ensure that the choices they offer reflect their policyholders' priorities. Some legal changes may be needed to facilitate this shift towards greater member involvement, both to clarify the extent to which members' views may be taken into account by trustees if it has not been possible to ascertain the views of *all* members, and to guarantee members an adequate level of disclosure and consultation.

The enlightened fiduciary

Finally, debates over the role of investors in the wake of the financial crisis suggest a need to look beyond beneficiaries. Collectively, pension funds are now important actors in the global economy, a far cry from the family trusts of the eighteenth century for whom fiduciary obligations first developed. The fiduciaries of today include giant institutions whose decisions have a very real impact on the economy, on society and on the environment. Does this impact justify granting rights to other stakeholders beyond the beneficiaries to whom fiduciary obligations are traditionally owed?

Ultimately, we conclude that this is not desirable. The duty of undivided loyalty is, as we have seen, at the heart of the fiduciary relationship. Undermining this would undermine the fundamental purpose of fiduciary obligation. However, there may be other ways of protecting the public interest and encouraging enlightened behaviour which do not interfere with the basic nature of the fiduciary relationship. Section 172 of the Companies Act 2006, which requires company directors to 'have regard' to the longer-term and wider consequences of their decisions, provides a useful model. This model preserves the primacy of fiduciaries' duty to their beneficiaries, but recognises that beneficiaries' long-term interests may often be best served by an enlightened approach.

Indeed, it is somewhat paradoxical that a similar provision has not been applied to institutional investors. The Companies Act provisions are based on the idea of 'enlightened shareholder value'. At present, there is a direct conflict between this model and the perception of many fiduciary investors - who are themselves the shareholders in question - that their legal obligations actively *prevent* them from taking an enlightened approach. This perhaps contributes to a situation where many directors report feeling under pressure from shareholders to maximise short-term returns even at the expense of long-term business growth. As policymakers seek to put the economy back on a stable and sustainable footing in the wake of the financial crisis, it is vital that they rectify this mismatch.

Conclusion

In light of all these issues, the time has come for a fundamental review of the fiduciary obligations of investors. Such a review has much to contribute to many of today's great policy challenges, from providing for an ageing society to achieving stable and sustainable economic growth. A rediscovery of basic fiduciary principles - in particular, the duty of loyalty to beneficiaries - would help refocus post-crisis debates about investment governance on the people

whose money is at stake, and on the need to ensure that the financial system acts as their servant and not their master. But it is also time to move on from an outdated view of fiduciary obligation as a straitjacket which prevents investors from behaving in an enlightened and responsible manner. We hope that this report and its recommendations will act both as a useful contribution to this crucial debate, and as a catalyst for action.

Key findings of this report

- Prevailing interpretations of fiduciary obligation have lost their way, neglecting the core duty of loyalty - including the duty to avoid conflicts of interest - in favour of a narrow focus on maximising returns.
- The rise of 'agency capitalism' - whereby the gains of investment activity go disproportionately to intermediaries rather than underlying owners - is inconsistent with the fiduciary concept. There is an urgent need to consider how fiduciary standards can be achieved, not just by trustees, but by all those responsible for managing other people's money.
- The increasing acceptance that sustainability and other 'ESG' factors can affect returns presents an opportunity to tackle the perverse incentive structures and misunderstandings of fiduciary obligation which continue to hold back responsible investment in practice.
- There is also a need for legal clarification of the extent to which pension funds can take non-financial factors into account for their own sake, to resolve a decades-old debate on 'ethical investment' that has generated more heat than light.
- In a world where pension fund members both provide the capital to be invested and bear the investment risk on that capital, it is right that they should be given more of a say in the management of their money.
- There is a need to align the legal framework governing investors with the 'enlightened shareholder value' ethos underpinning the duties of company directors, encouraging a responsible, long-term approach to serving beneficiaries' interests.

For a full summary of our specific recommendations to government, regulators and investors, please see pages 127-129.

Introduction

“The rise of mutual funds and retirement plans means that the actual owners of the world’s corporations are no longer a few wealthy families. They are the huge majority of working people who rely on today’s largest companies to safeguard their pensions and life savings”

‘The New Capitalists: How Citizen Investors are Reshaping the Corporate Agenda’,
Davis, Lukomnik & Pitt-Watson

In the aftermath of the financial crisis of 2008, both investors and policymakers have become acutely aware of the importance of investor behaviour to good governance of companies. It is now widely acknowledged that many institutional investors either acted as ‘absentee landlords’ by failing to effectively oversee the risk management of the banks they owned, or, worse, actively encouraged risky strategies as a means for achieving short-term returns. One outcome of this has been the UK Stewardship Code, designed to encourage UK institutional investors to act as responsible owners of companies and not just traders in stocks.

But one relationship which has received less attention than that between company and shareholder, or even between asset manager and asset owner, is the relationship between all these agents and the underlying owners - the ordinary savers whose money is at stake. It is this

relationship that this report is primarily concerned with. We believe that a renewed focus on investors’ fiduciary obligations would rebalance post-financial-crisis policy debates in favour of those who provide the capital, depend on the performance of their investments, and ultimately pay the price when things go wrong.

The behaviour of investors is not only of concern to those with an interest in corporate governance. It is also absolutely central to our ability as a society to meet the challenges of an ageing population. Increasingly, people depend on private pension savings to give them a decent standard of living in retirement. And, with the decline of final salary schemes, the level of their retirement income is increasingly determined by the performance of their investments. As such, whether fiduciary investors are serving their beneficiaries’ interests should be of crucial concern to anyone involved in pensions policy.

But is our current understanding of fiduciary obligation well-equipped to meet these challenges? The effects of investment agents’ behaviour on those whose money they manage go far beyond the size of their pension pot, yet ‘fiduciary duty’ is often treated as a straitjacket which allows investors to consider nothing else. For instance, fiduciary obligation is often still invoked as a barrier to investors taking full account of climate change in their decisions - despite its enormous implications for their beneficiaries’ best interests, both financial and non-financial. Individuals who enquire about their pension fund’s stance on an ethical issue often encounter the seeming paradox

of being told that their views must be ignored because of the fund's duty to act in their best interests. And, despite increasing awareness of the importance of systemic risks, investor notions of fiduciary obligation provide little encouragement either for considering ways to collectively minimise those risks, or for ensuring that their own behaviour as significant economic actors does not exacerbate them. Just as fiduciary obligation evolved in the twentieth century to keep pace with

changing investment theory and practice, so perhaps it will need to evolve in the twenty-first.

In this context, FairPensions convened a series of expert seminars to consider whether investors' fiduciary obligations are fit for purpose, and, if not, how they might be rethought. Each seminar featured a presentation from an expert in their field and considered a particular aspect of fiduciary obligation (see Box A below).

Box A: Seminars

Seminar 1: Identifying key themes
(Professor Keith Johnson)

This seminar gave an overview of the history of fiduciary obligation and considered some key characteristics of contemporary pension investment, together with their implications for traditional conceptions of fiduciary obligation.

Seminar 2: Fiduciaries redefined & prudence redefined
(Paul Watchman)

This seminar considered two key issues:

- Firstly, is the traditional emphasis on the trustee as fiduciary outdated? Should fiduciary obligations be extended to asset managers, consultants and other actors?
- Secondly, what are the barriers to a refined understanding of 'prudence' that takes full account of environmental, social and governance (ESG) issues, as recommended by the Freshfields Report of 2005?

Seminar 3: Best interests redefined
(Charles Scanlan)

This seminar considered the core notion that fiduciaries must act in beneficiaries' 'best interests'. It asked two questions:

- Firstly, does the duty to act in beneficiaries' best interests always and necessarily refer to their financial interests, or can trustees adopt a wider approach which takes account of beneficiaries' ethical or social best interests?
- Secondly, to what extent can or should beneficiaries play a role in determining their own best interests, rather than relying solely on trustees' assessment of their interests?

Seminar 4: Beneficiaries redefined
(David Howarth)

This seminar asked whether a model of fiduciary duty based on a sole obligation to beneficiaries remains appropriate given the scale and influence of pension investments on the global economy, or whether more regard should be paid to the interests of other stakeholders.

The seminars highlighted a number of ways in which today's changing pension and investment landscape has implications for fiduciary obligation. This report attempts to tackle these issues by rediscovering the fundamental principles of fiduciary obligation and asking how they can be applied to a world very different from one in which the existing legal framework developed. **Chapter 1** lays the foundation for this by exploring the legal and historical roots of fiduciary obligations and looking at how today's interpretations have drifted from those roots. The remaining chapters apply this understanding to a variety of key issues:

Chapter 2 asks whether the increasing delegation of investment decisions by trustees renders outdated the traditional focus on the fiduciary status of trustees themselves, rather than of their various agents, such as asset managers and investment consultants. It also considers the implications of the shift from trust-based to contract-based pension arrangements, which is taking an increasing number of savers out of the fiduciary sphere altogether, raising the question of how we can ensure that levels of protection are the same for all pension savers regardless of the form of their provision.

Chapter 3 asks what the barriers are to the integration into mainstream investment practice of environmental, social and governance (ESG) issues which can have a material impact on financial returns.

Chapter 4 asks whether the fiduciary framework can meet individual savers' increasing expectation that their ethical preferences should be taken into account in the management of their money. It challenges the perception - based on a small number of widely-misunderstood legal cases - that fiduciary obligation prevents pension funds from taking beneficiaries' non-financial interests into account for their own sake, and asks under what circumstances this might be possible.

Chapter 5 asks whether beneficiaries - particularly pension fund members - should have more of a role in determining their own best interests. With the shift from defined benefit to defined contribution provision, pension savers not only provide the capital to be invested but also increasingly bear the investment risk. This calls into question the appropriateness of the beneficiary's traditionally passive role in the fiduciary relationship.

Chapter 6 considers the implications of pension providers' status as major economic actors - a far cry from the family trusts of the eighteenth century. Does this status create a public interest in the behaviour of fiduciary investors, and if so, how can it be protected without compromising the fiduciary relationship?

The background is a solid purple color. On the left side, there are two horizontal bars: a light purple bar at the top and a white bar below it. On the right side, there is a large, stylized number '1' in a lighter shade of purple, which is partially cut off by the right edge of the page.

Chapter

Forgotten Roots, Future Challenges

Rediscovering the core elements
of fiduciary obligation

“ A fiduciary must act in good faith;
he must not make a profit out of his trust;
he must not place himself in a position
where his duty and his interest may conflict;
he may not act for his own benefit or
the benefit of a third person without the
informed consent of his principal ”

Bristol and West Building Society v Mothew

Fiduciary obligation is the scrupulously high standard of care and integrity that is required when one person is entrusted to act on behalf of another. In the world of modern investment, where millions of people are heavily dependent for their wellbeing in later life on the agents who look after their pensions and other savings, such protection is more vital than ever.

This report asks whether this ancient protective legal concept is fulfilling its purpose in the twenty-first century. Both the way in which assets are invested and the way in which investors think about their fiduciary obligations have changed dramatically over time - so much so that the two may be out of step. This chapter attempts to go back to first principles, exploring the nature and purpose of fiduciary obligation and examining its historical and legal roots. It focuses on English law, but draws on examples and landmark legal cases from other jurisdictions, including the United States. It concludes that our understanding of fiduciary obligation has lost its way, and that there is an urgent need to rediscover its essence if savers are truly to be protected by it.

“ Our understanding of fiduciary obligation has lost its way, and that there is an urgent need to rediscover its essence if savers are truly to be protected by it ”

What is a fiduciary relationship?

Fiduciary obligation is a common-law concept. This means that, although the duties of some specific ‘fiduciary’ actors - such as company directors¹ - are set out in statute, there is no general statutory definition of ‘fiduciary obligation’, or even of who or what a ‘fiduciary’ is. Indeed, the Law Commission has described the nature and scope of fiduciary obligations as “*highly complex, poorly delimited, and in a state of flux.*”² Legal authority on the subject comes mostly from case law. The English courts have defined a fiduciary as “*someone who has undertaken to act for and on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence.*”³ This applies not only to those entrusted with another’s property, such as investment agents, but also to those responsible for their other vital interests, such as lawyers, legal guardians and teachers.

The idea of ‘trust and confidence’ is often interpreted so as to emphasise the beneficiary’s reliance on the good faith of their fiduciary: the Law Commission describes the key characteristics of the fiduciary relationship as “*discretion, power to act, and vulnerability.*”⁴ Imbalances of knowledge and power make the beneficiary vulnerable in relation to the fiduciary, creating “*a bond of responsibility and dependency.*”⁵ Often this is related to the beneficiary’s inability to control that part of their affairs over which the fiduciary has largely unfettered discretion.

¹ Section 172, *Companies Act 2006* ² Law Commission, 1992, ‘*Consultation Paper No. 124: Fiduciary Duties and Regulatory Rules*’ (HMSO), para 2.4.1 ³ *Bristol and West Building Society v Mothew* [1996] 4 All ER 698 ⁴ Law Commission, 1992, *op cit*, para 2.4.7 ⁵ Richardson, B.J. ‘*Keeping Ethical Investment Ethical: Regulatory Issues for Investing for Sustainability*’, *Journal Of Business Ethics* (2009) 87:562 ⁶ A. Hudson, *The Law on Investment Entities* (London: Sweet and Maxwell, 2000) at 85-86., cited in Richardson 2007, *op cit*, p153 ⁷ *Bristol and West Building Society v Mothew* [1996] 4 All ER 698 ⁸ This remained the case until the enactment of section 29 of the *Trustee Act 2000*, which, subject to certain exceptions and conditions, created an implied charging clause authorising “*reasonable*

“ Imbalances of knowledge and power make the beneficiary vulnerable in relation to the fiduciary ”

There is some uncertainty over when this relationship arises in an investment context. In the case of investment trusts, there is an unambiguous fiduciary relationship between trustee and beneficiary, as between pension scheme trustees and their members, or between charitable trustees and their charity. But for other investment agents, the position becomes less clear-cut, as we shall see in Chapter 2.

A brief history of fiduciary obligation

The concept of fiduciary obligation can be traced back to Roman law: the word ‘fiduciary’ itself comes from the Latin ‘fiducia’, meaning ‘trust’. The modern concept has evolved haphazardly, with little legislation, little authoritative case law and little official guidance for trustees on how to interpret their fiduciary duties. Its legal origins are to be found in medieval England, where it usually served to protect the entitlements of individuals with assets held in trust by another, such as orphaned children whose guardians held the legal rights to their property. Trustees were generally friends or family members, and the assets in question more often land or property than money to be invested.⁶

The fiduciary duties of trustees in an investment context are many and varied, having built up over several centuries of

case law (see Box A). However, the two core fiduciary duties from which most others derive are those of loyalty and prudence.

The duty of loyalty

In order to prevent them from abusing their position for personal gain, fiduciaries owe a duty of undivided loyalty to their beneficiaries. The requirement to act in the sole interests of beneficiaries (sometimes called the ‘sole interest standard’) entails:

- a duty to act in good faith
- a duty to avoid putting themselves in a position where their interests and the interests of beneficiaries might conflict
- a prohibition on deriving personal profit from the exercise of their fiduciary powers without the beneficiaries’ informed consent⁷

Originally, this duty to avoid conflicts of interest was extremely strict: professional trustees could not even be paid for their time without explicit authorisation.⁸ Trustees who derived *unauthorised* profit from their activities were found to be in breach of their fiduciary duties even if their actions had actually *benefited* the trust.⁹ There is some debate over the extent to which this ‘sole interest’ standard still applies today. English courts appear to feel bound by the strict interpretation of fiduciary obligations dictated by legal precedent - although opinion is divided over whether this standard remains appropriate. Some have argued that the sole interest rule is outdated and should be relaxed in cases where the trustee acted in good faith and in the best interests of the beneficiaries.¹⁰

remuneration” for professional trustees of trusts that do not make express provision for such remuneration. Unless the trustee is a trust corporation, this entitlement to remuneration does not apply to a sole trustee and is dependent upon the agreement in writing of each of the other trustees. The Explanatory Notes to the Act state: “*In determining whether to give such agreement, trustees will be subject to their paramount duty at common law to act in the best interests of the present and future beneficiaries of the trust*”⁹ Boardman v Phipps [1966] UKHL 2, [1967] 2 AC 46, [1966] 3 WLR 1009, [1966] 3 All ER 721

“In order to prevent them from abusing their position for personal gain, fiduciaries owe a duty of undivided loyalty to their beneficiaries”

In the United States, it has been suggested that this more liberal standard is the one the courts apply in practice, reflecting the desirability of managing conflicts of interest rather than avoiding them altogether.¹¹

Others have defended the strictness of fiduciary accountability as being essential to what distinguishes it from merely contractual relationships,¹² arguing that the purpose of strict fiduciary obligations is to eliminate absolutely the risk of fiduciaries being “swayed by interest rather than by duty,”¹³ by deterring them from acting without the consent of the beneficiary in situations where they are conflicted. There is little reason to assume that this risk is no longer relevant today - indeed, in light of some of the excesses that preceded the financial crisis, it may be more relevant than ever.¹⁴

Notwithstanding this disagreement over how strictly the duty of loyalty should be interpreted, nobody disputes that it is still the overriding obligation of fiduciaries, including fiduciary investors. Indeed, in the case of pension fund trustees (or their equivalents in civil law countries), the duty of loyalty now forms an explicit

part of European law under the EU “IORP” Directive.¹⁵ The Directive provides that “[pension scheme assets] shall be invested in the best interests of members and beneficiaries. In the case of a potential conflict of interest, the institution, or the entity which manages its portfolio, shall ensure that the investment is made in the sole interest of members and beneficiaries.”¹⁶

The duty of undivided loyalty, and the focus on conflicts of interest which it entails, is therefore far from being a forgotten relic of a bygone era. Indeed, in a very recent case, an English court reiterated that this duty is the crux of what fiduciary obligation is about:

*“The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary.”*¹⁷

The duty of prudence

The classic statement of the fiduciary duty to invest prudently under English law comes from the case of *Re Whiteley* (1886):

*“The duty of a trustee is ... to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide.”*¹⁸

A ‘prudent person rule’ is now incorporated into the statutory obligations of trustees in several jurisdictions.¹⁹ In the UK, however, no such general statutory duty applies to the exercise of pension trustees’

¹⁰ See for example Panesar, 2007, ‘The Nature of Fiduciary Liability in English Law’, *Conv* 2, pp11-19, cited in Pearce, Stevens & Barr, 2010, ‘The Law of Trusts and Equitable Obligations’, 5 ed. (Oxford University Press), p944

¹¹ Langbein, ‘Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?’, *Yale Law Journal* 114 (2005), p969 ¹² See for example Flannigan, ‘The Core Nature of Fiduciary Accountability’, *New Zealand Law Review* (2009), Vol. 2009, p. 375; Samet, ‘Guarding the Fiduciary’s Conscience - A Justification of a Stringent Profit Stripping Rule’, *Oxford Journal of Legal Studies* (2008), Vol. 28, No. 4, pp. 763-781 ¹³ *Bray v Ford* [1896] AC 44, 51, cited by Conaglen, M. 2010, ‘In Defence of the Strictness of Fiduciary Accountability’, p12 (available at www.chba.org.uk/library/?a=89439) ¹⁴ See Conaglen, 2010, op cit, p12 ¹⁵ Directive 2003/41/EC of the European Parliament and of the Council of the European Union of 3rd June 2003 “on the activities and supervision of institutions for occupational retirement provision” ¹⁶ Article 18.1 (a). In the UK, this requirement is given effect in relation to trustees and

investment powers.²⁰ The common law rule in *Re Whiteley* is therefore still the primary source of authority, subject to additional regulations.

The duty of prudence has evolved considerably over the centuries in order to keep pace with changing investment theory and practice. Originally, prudence meant caution and risk-aversion - focussing on the protection of beneficiaries' assets rather than the maximisation of return on their investment.²¹ After the collapse of the South Sea Bubble in 1720, which resulted in heavy losses for many investment trusts, the 'legal list' approach to permitted investments was introduced, requiring trustees to invest only in asset classes considered 'safe' and to avoid those considered risky. In the American case of *King v Talbot* (1869), "*the preservation of the fund*" was held to be paramount, with the judge ruling that the duty of prudence "*necessarily excludes all speculation*."²² *Re Whiteley* reiterated that English trustees must "*avoid all investments of that class which are attended with hazard*."²³

“Originally, prudence meant caution and risk-aversion - focussing on the protection of beneficiaries' assets rather than the maximisation of return”

Until relatively recently, this system forbade trustees to invest in equities (unless expressly authorised by their governing trust deed). As this approach became incompatible with the tenets of modern investment, such restrictions were gradually loosened. This process began in Massachusetts, where a landmark case in 1830 found that the English rule that stocks were improper investments did not apply to American trust law. Instead, trustees simply had a broad duty

*“to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.”*²⁴

Today this is the classic statement of the 'prudent man rule' in American law - but it did not become widespread for over a century.

In the UK, a 1961 Act of Parliament removed the 'legal list' system and created a positive duty on trustees to "*have regard to the need for diversification*."²⁵ But it was only a partial deregulation; significant restrictions continued to be imposed on trustees' exercise of investment powers, reflecting the traditional emphasis on conservative investment approaches.²⁶ These restrictions were only finally removed in relation to pension schemes by the Pensions Act 1995,²⁷ and in relation to other trusts by the Trustee Act 2000,^{28/29} after a landmark judgement in 1993 which

delegated fund managers by The Occupational Pension Schemes (Investment) Regulations 2005, (SI 2005/3378), Regulation 4(2) ¹⁷ *Bristol and West Building Society v Mothew* [1996] 4 All ER 698. This was reiterated by the Australian Federal Court in *ASIC v Citigroup* [2007]. ¹⁸ *Re Whiteley* [1886] LR 33 Ch D 347 ¹⁹ For example, the US Employee Retirement Income Security Act (ERISA) 1974 ²⁰ The statutory duty of care which applies to trustees under Section 1 of the Trustee Act 2000 does not apply to the trustees of occupational pension schemes in relation to their investment powers (Section 36, Trustee Act 2000). ²¹ See for example *King v Talbot*, *Re Whiteley*, *Harvard v Amory* (notes 21, 22, 23) ²² *King v Talbot*, 40 N.Y. 76 [1869] ²³ *Re Whiteley* [1886] LR 33 Ch D 347 ²⁴ *Harvard v Amory* 26 Mass. 446, 469 [1830] ²⁵ Trustee Investments Act 1961, Section 6(1)(a) ²⁶ Trustee Investments Act 1961, Section 2 ²⁷ Pensions Act 1995. Section 34. ²⁸ Trustee Act 2000, Section 3 ²⁹ In practice, by this time most pension schemes and other trusts had express provisions giving wide investment powers, so in both cases these legislative changes were less radical than might appear.

“ Perhaps now is the moment to reassert an older concept of fiduciary obligation as a duty to protect ”

recognised the primacy of modern portfolio theory in the application of the prudent investor rule.³⁰ The duty to diversify in relation to occupational pensions now forms part of European law under the “IORP” Directive.³¹

This recognition of modern portfolio theory represented an evolution in one other important sense: the duty of prudence came to be interpreted in terms of ensuring a sensible investment strategy for the portfolio as a whole, rather than in terms of the characteristics of individual assets taken in isolation.³² For instance, assets formerly deemed ‘speculative’ might form a reasonable part of a properly diversified portfolio; conversely, there is no requirement to ‘maximise’ return in relation to individual assets.³³

Interestingly, The Pensions Regulator (TPR) has recently hinted at the revival of restrictions on asset classes for pension schemes engaging in risky strategies in an attempt to fill large deficits.³⁴ In his final speech as chair of TPR, David Norgrove was firm: *“It’s not right for schemes to take excessive investment risks to bridge the funding gap where there is a fragile*

*employer. This is essentially gambling with other people’s money.”*³⁵ This reflects a growing recognition that the availability of riskier asset classes has not always served the best interests of beneficiaries. While not suggesting a return to the ‘legal list’ system, perhaps now is the moment to reassert an older concept of fiduciary obligation as a duty to protect - to avoid ‘gambling with other people’s money’.

Box A: Key obligations of fiduciary investors

- The duty to act in accordance with the purposes of the trust, and within the powers conferred
- The duty to act in the best interests of beneficiaries (and, in case of conflict, in their sole interest)
- The duty to act in good faith
- The duty to avoid conflicts of interest, and not to exercise powers in one’s own interest or those of third parties
- The duty to act impartially as between classes of beneficiary³⁶
- The duty to invest prudently
- The duty to maintain a properly diversified portfolio
- The duty to take account of all relevant considerations and discard irrelevant considerations³⁷
- The duty to seek advice

³⁰ Nestle v National Westminster Bank plc [1993] 1 WLR 1260 ³¹Article 18.1 (e), translated into UK law by the Occupational Pension Schemes (Investment) Regulations 2005, Regulation 4(7) ³² See also American Law Institute’s Third Restatement of Trusts (Prudent Investor Rule). (Washington DC: ALI, 1990) 8 (section 227) ³³ See for example UNEP-FI, 2005, ‘A legal framework for the integration of environmental, social and governance issues into institutional investment’, pp 8-9, 110 ³⁴ IPE, 7 Dec 2009, ‘TPR to limit schemes’ exposure to high-risk assets’ ³⁵ David Norgrove, Speech to National Association of Pension Funds Annual Trustee Conference, Dec 2010. Available online at www.thepensionsregulator.gov.uk/doc-library/david-norgrove-napf-annual-trustee-conference-speech.aspx . See also TPR’s guidance, November 2010, ‘Monitoring Employer Support’, para 26: *“In cases of very weak (or negligible) employer covenant, trustees need to justify why an investment policy that includes the acceptance of significant risk is in the best interests of scheme members.”* ³⁶ See for example Elliott v Pensions Ombudsman [1998] OPLR 21 ³⁷ See for example Sieff & Ors v Fox & Ors [2005] EWHC 1312

Fiduciary obligation today: a concept that has lost its way?

It is widely assumed that the function of fiduciary duty in an investment context is, plainly and simply, to ensure that beneficiaries get the highest risk-adjusted financial return on their capital. This assumption is at the heart of the presumed 'fiduciary barrier' to responsible or ethical behaviour by trustees exercising investment functions. But is it the whole story? And is this conception of fiduciary duty actually delivering in the best interests of beneficiaries?

Avoiding conflicts of interest: a neglected fiduciary duty?

As we have seen, in its original context the duty to act in beneficiaries' 'best interests' - the duty of loyalty - was not directly concerned with investment performance; that was the function of the duty of prudence. Instead, it was about the duty to put beneficiaries' best interests *above those of the fiduciary* - to avoid conflicts of interest, to act in good faith, and not to misuse trust property for their own ends. This goes to the heart of the original purpose of fiduciary obligations - to *protect* beneficiaries from reckless or self-interested behaviour by those entrusted with their property. Stripped of these historical origins, fiduciary obligation is often spoken about as if its sole purpose is to optimise investment returns, while the duty to avoid conflicts of interest is neglected or forgotten - particularly as regards agents in the investment chain, as opposed to trustees themselves (for more on this, see Chapter 2).

A preoccupation with 'ethical investment' in debates about fiduciary obligation has fuelled this misunderstanding. Putting aside one's personal interests and doing what is best for the beneficiary will, of course, include not indulging one's personal political, social or ethical views at the expense of serving beneficiaries' interests. But the key issue at stake for the duty of loyalty is not one of financial versus non-financial interests, but of the *beneficiaries'* interests versus the *fiduciaries'* interests.³⁸ These two issues have too often been conflated in mainstream debates, obscuring the duty's broader purpose.

Prudence and systemic risk

If the duty of loyalty is often misunderstood, then what about the duty of prudence? As we have seen, until relatively recently the focus of fiduciary duties in an investment context was very much on the protection of beneficiaries' assets rather than on the maximisation of return: in other words, on wealth preservation rather than wealth creation. In current interpretations of fiduciary obligation, this assumption seems to have been reversed. Of course, this is not to suggest that risk has left the equation - the common assumption, following the judgement in *Cowan v Scargill*, is that fiduciary duty entails obtaining the best possible return "*judged in relation to the risks.*"³⁹ But maximising return has nonetheless taken the place of minimising risk as the presumed primary objective of the fiduciary investor.

³⁸ On the separate question of whether trustees can take into account beneficiaries' own non-financial interests, see Chapter 4. ³⁹ *Cowan v Scargill* [1984] 2 All ER, 750 at page 760 [1985] Ch 270

Interestingly, there is some recent legal precedent questioning this interpretation. Nobody suggests that pension fund trustees do not or should not have a duty to seek a high return for beneficiaries. But a distinction can be made between seeking a high return and seeking the maximum return regardless of other considerations. For instance, a US court has held that *“a trustee’s duty is not necessarily to maximise the return on investments but rather to secure a ‘just’ or ‘reasonable’ return while avoiding undue risk.”*⁴⁰ Similarly, the judge in one landmark Scottish case on socially responsible investment (see chapter 4) remarked, *“I cannot conceive that trustees have an unqualified duty simply to invest trust funds in the most profitable investment available.”*⁴¹ Yet many do appear to interpret fiduciary obligation as precisely that.

The attitudes of pension savers themselves still seem to have more in common with the traditional view of prudence than with today’s model. Beneficiaries have been shown to be more risk-averse than those acting on their behalf in the investment industry.⁴² When NEST undertook research into its likely membership, it found that they were likely to be more concerned about avoiding loss than achieving high returns, with consumer groups suggesting that they should therefore *“adopt a building society mentality with the aim to preserve capital.”*⁴³

It has been countered that beneficiaries’ low appetite for risk reflects their lack of understanding of investment, and is in fact inconsistent with their hoped-for level

of retirement income. Of course, there can be no return without risk, and we are certainly not suggesting that the clock can or should be turned back to pre-twentieth century models of investing. But it is worthwhile to stop and assess whether current interpretations of prudence are really delivering for beneficiaries even on their own terms. Certainly, the 1.1% average annual real return achieved by UK pension funds in the period 2000-2009 is disappointing, particularly when compared with the 4.1% annual average over the whole period since 1963.⁴⁴

In recent years, the objective of maximising returns has in practice been limited to short-term returns judged against a benchmark. Notwithstanding the general trend towards de-risking among UK pension schemes - largely accounted for by mature schemes, closed to new members⁴⁵

“ *Fiduciaries have perhaps been too focussed on chasing alpha (ie. outperformance against the market), even though evidence suggests that the vast majority of variation in pension funds’ returns is attributable to asset allocation decisions and the resulting beta exposure* ”

⁴⁰ Board of Trustees of Employment Retirement System of the City of Baltimore v City of Baltimore 562 A.2d 720, 317 Md. 72 [1989] ⁴¹ Martin v City of Edinburgh 1988 SLT 329, 1988 SCLR 90 ⁴² See for instance Collard, S. January 2009, ‘Individual Investment Behaviour: A Brief Review of Research’ (University of Bristol), p4; PADA, 2009, ‘Building personal accounts: Designing an investment approach’, pp26-30; Richards, ‘The Evolving Role of the Pension Fund Trustee’, Pensions 8(1), 2002 ⁴³ PADA, 2009, ‘Building personal accounts: Designing an investment approach’, p28 ⁴⁴ Paul Woolley, ‘Why are financial markets so inefficient and exploitative - and a suggested remedy’, in LSE, 2010, ‘The Future of Finance’, p135

- many pension providers do seem to privilege the pursuit of short-term return while neglecting important determinants of long-term return. Fiduciaries have perhaps been too focussed on chasing alpha (ie. outperformance against the market), even though evidence suggests that the vast majority of variation in pension funds' returns is attributable to asset allocation decisions and the resulting beta exposure (ie. the performance of markets themselves).⁴⁶ The recent rise in passive management suggests that trustees are increasingly recognising the pitfalls of these strategies.

But an even more fundamental challenge for the prudent trustee is posed by systemic risk: factors which arise not just at the level of individual firms or even sectors, but which affect entire markets or financial systems. In the wake of the financial crisis, it is increasingly clear that such risks can be pivotal to outcomes for beneficiaries. Both the old and the new concepts of prudence are ill-equipped to deal with such risks. The traditional assumption that risk could be minimised by avoiding 'risky' asset classes is clearly outdated. But the modern assumption that risk can be calculated and managed through diversification may also be flawed, as it fails to take account of systemic risk factors which can overwhelm the risk assumptions. For instance, as a recent Mercer report noted, investors cannot avoid the risks associated with climate change by shifting to more 'conservative' asset classes or by diversifying across asset classes: instead they must seek to diversify across *sources* of risk.⁴⁷

“ Just as fiduciary obligation evolved in the twentieth century to come to terms with the maxims of modern portfolio theory, so there may be a need for it to evolve in the twenty-first ”

This is particularly important for pension funds, who tend to be 'universal owners' with holdings across all economic sectors and for whom the performance of the economy as a whole therefore matters far more than the profitability of any individual asset in their portfolios. Although the idea of universal ownership is beginning to be explored by some pension funds, there is still a lack of clarity over what it means in practice (see Chapter 4). Arguably, universal owners have a responsibility to engage with the broader economy and the policy framework that governs it, given that such factors are likely to affect outcomes for their beneficiaries at least as much as the level of outperformance achieved by the fund's managers. Today's understanding of the duty of prudence may not help fiduciaries to think about these increasingly vital issues.

⁴⁵ See for example IMA Annual Survey, 2009-2010, p31 ⁴⁶ See for example Brinson et al, 1991, 'Determinants of Portfolio Performance II: An Update', Financial Analysts Journal vol 47, no. 3 (May/June): 40-48; Ibbotson, 'The Importance of Asset Allocation', Financial Analysts Journal Vol 66 No 2 (March/April 2010) ⁴⁷ Mercer, 2011, 'Climate Change Scenarios - Implications for Strategic Asset Allocation', Executive Summary.

Just as fiduciary obligation evolved in the twentieth century to come to terms with the maxims of modern portfolio theory, so there may be a need for it to evolve in the twenty-first to come to terms with the challenges posed by systemic risk. Combined with a renewed appreciation of the historical roots of the duty of prudence (ie. the desirability of preserving beneficiaries' capital), such a reassessment could help to ensure that fiduciary obligation is doing its job of protecting beneficiaries in the post-financial-crisis era.

A duty to herd?

How in practice can investors deal with systemic risk? By definition, such issues are difficult for them to take account of acting alone. Part of the answer may lie in a greater focus on collaborative initiatives among investors, including those seeking to address issues at the systemic level, for instance by working with policymakers and regulators. The Institutional Investors' Group on Climate Change is one example of such an initiative.

There is also a need to consider whether prevailing interpretations of fiduciary obligation may be causing pension funds to exercise their significant economic power in a way which actually exacerbates systemic risk - for instance, by encouraging herding behaviour. The 'prudent man' standard has always been to some extent a relative one: for instance, Harvard v Amory states that trustees must "*observe how men of prudence, discretion, and intelligence manage their own affairs.*"⁴⁸ According to Claire Woods of Oxford University, English courts have since tended to interpret the duty of prudence

*"in such a way as to encourage fiduciaries to adhere to the status quo."*⁴⁹ As Prof. Keith Johnson pointed out in his paper for our first seminar, this was not a problem when the value of assets held in trust was relatively small - but, with the advent of pension funds as major institutional investors, it has serious implications for financial stability:

*"Today investors herd around short-term investment strategies adopted by other prudent experts who manage similar funds. This has unleashed a flock of 900-pound lemmings into the economy."*⁵⁰

This link between 'prudence' and herding behaviour has two inter-related consequences. Firstly, as Claire Woods argues, it creates a fear of departing from industry norms which makes both the industry and the legal framework extremely slow to adapt to changing realities. This fear is made all the more acute by the fact that trustees are personally liable for any breach of their fiduciary obligations - fostering an attitude which has been described as 'reckless caution'. As we have seen, conceptions

“ Prevailing interpretations of fiduciary obligation may be causing pension funds to exercise their significant economic power in a way which actually exacerbates systemic risk ”

⁴⁸ Harvard v Amory 26 Mass. 446, 469 [1830] ⁴⁹ Woods, C. forthcoming, 2011, 'Funding climate change: how pension fund fiduciary duty masks trustee inertia and short-termism'. in Hawley, J., Kamath, S. and A.T. Williams (eds.) *Corporate Governance Failures: The Role of Institutional Investors in the Global Financial Crisis*. (University of Pennsylvania Press) ⁵⁰ Johnson, K. 2010, 'Back to the Future of Pension Fund Trust Fiduciary Duties' (available online at www.fairpensions.org/sites/default/files/uploaded_files/KeithJohnsonFiduciaryDuty.pdf) p3

of fiduciary obligation took decades to fully adapt to the recognition of modern portfolio theory. Today, the same difficulty is being faced by the integration of climate change and other extra-financial factors into investment strategies: legal uncertainty combined with a cautious attitude to what is ‘prudent’ creates “a perception among trustees that it is safest not to test these waters”⁵¹ (see chapter 3).

Secondly, it can lead to an unhealthy focus on benchmark-relative performance, distracting from the ultimate goal of creating long-term value for beneficiaries. Prevailing interpretations of prudence perhaps help to explain Lord Myners’ characteristically colourful observation that:

*“People’s pensions are not paid by relative performance but absolute performance, yet this industry is obsessed with relative performance ... In this world, it is fine to be wrong or even lose money, as long as you do so in the company of others.”*⁵²

This standard of prudent behaviour becomes particularly counter-productive when the conventional wisdom of the market reflects ‘irrational exuberance’ - as many would accept was the case in the build-up to the financial crisis. It is also problematic if the norms being followed do not match the objectives or time horizons of the scheme’s beneficiaries. If the purpose of the duty of prudence is to ensure that beneficiaries’ savings are invested wisely, in a pensions context it would be reasonable to assume that a ‘prudent’ strategy would be one designed

to ensure long-term stable growth, safeguarding the retirement income of the fund’s youngest beneficiaries as well as the oldest. Yet, as Woods argues, in practice the reverse may be true: “*In circumstances such as the present, where investors are typically driven by short-term performance, prudent investment becomes short-term investment.*”⁵³

Thus, despite being inherently long-term investors, pension funds remunerate their asset managers based on short-term performance measures (see Chapter 3). In addition, many have been swept up in the extraordinary growth in churn in the equity markets as a whole - now at 150% per year of aggregate market capitalisation.⁵⁴ This has generally been poor value for beneficiaries: indeed, Paul Woolley has calculated that management fees and trading costs, based on 100% annual turnover, could erode a pension’s value by 1% a year - resulting, if continued, in an average 30% loss to the end-value of the pension.⁵⁵ Yet few trustees worry that these poor outcomes could mean they are breaching their fiduciary duties - albeit they may well be concerned about them for other reasons. As one pension trustee characterised it in our first seminar: “*in the herd, you’re safe, regardless of what happens to the members’ benefits.*”

The concept of ‘prudence’ is inherently difficult to define, and it is not surprising that it has developed into a standard that is judged against the actions of others. The prudent man standard is essentially a reasonableness standard, and, as in other areas of the law, necessarily refers to what another reasonable person would have

⁵¹ Woods, 2011, *op cit* ⁵² Lord Myners, March 2010, Speech to the International Corporate Governance Network, cited in Johnson, K. 2010, *op cit*, p4 ⁵³ Woods, 2011, *op cit* ⁵⁴ Woolley, P. 2010, *op cit*, p133 ⁵⁵ Woolley, P. 2010, *op cit*, p134 ⁵⁶ Martin v City of Edinburgh [1988] SLT 329, 1988 SCLR 90 (The wording quoted is from the headnote to the case report.)

“It is a vital principle of fiduciary obligation that fiduciaries cannot outsource their obligation to think”

done in the circumstances. However, if interpretation swings towards what Keith Johnson calls a ‘lemming standard’, this could become damaging to beneficiaries’ interests. Nor does it accord with the law’s emphasis on the process of trustee decision-making, and the requirement that trustees “*appl[y] their minds separately and specifically to the question whether [the decision at hand] would be in the best interests of the beneficiaries.*”⁵⁶ It is a vital principle of fiduciary obligation that fiduciaries cannot outsource their obligation to think. It therefore seems unlikely that a court today, particularly in light of the financial crisis, would in fact treat following the herd as synonymous with fulfilling the duty of prudence.

Measures could be taken to steer the interpretation of prudence in a more positive direction without waiting for a court judgement to this effect. One possible model for statute or guidance is the formulation of directors’ duties in the Companies Act 2006, which requires them, in promoting the success of the company, to have regard to “*the consequences of any decision in the long-term*”.⁵⁷ For a discussion of how this thinking might be applied in an investment context, see Chapter 6.

This is not to suggest that misunderstandings of the duty of prudence are by any means the only factor at play, or that a renewed interpretation of this duty would be a panacea for short-termism. Clearly, pension funds struggling with enormous deficits face a real imperative to maintain returns in the short-term. Balancing this with the long-term needs of fund members presents a genuine dilemma. But there is a danger that prevailing interpretations have helped to tilt the balance against the long-term. Professor Keith Johnson has suggested that one way of restoring this balance may lie in another fiduciary duty: what he calls ‘the ‘forgotten duty of impartiality’.

The ‘forgotten duty of impartiality’

The duty of impartiality requires trustees to act impartially as between different classes of beneficiary.⁵⁸ Although this duty is alive and well in judicial decisions (indeed, it was an important factor in the case of *Cowan v Scargill*, discussed in Chapter 4), its implications do not seem to be reflected in the investment policies of many schemes. Johnson argues that a full appreciation of the duty of impartiality would require trustees to act for the long-term in order to ensure intergenerational equity between their youngest and oldest members. As well as being a valuable counterweight to the ingrained short-termism of the financial markets, this offers a framework for trustees to think about questions of ecological sustainability.

⁵⁷ Section 172(1)(a), Companies Act 2006 ⁵⁸ Johnson and de Graaf, ‘*Modernising Pension Fund Legal Standards for the 21st Century*’, Rotman International Journal of Pensions Management, Spring 2009, Vol 2, Issue 1 ⁵⁹ This was raised in some responses to the Myrers Review: see Myrers, P. 2001, ‘*Institutional investment in the United Kingdom: A review*’ (HM Treasury), para 5.68

In debates about short-termism it is sometimes countered that ‘the long term is just a series of short terms’.⁶⁰ If this were the case, there would be no conflict between the interests of younger and older beneficiaries: both would be best served by maximising return in each short-term performance period. But, as Mark Mansley of Rathbone Greenbank has noted, this argument assumes that returns in each short-term period are independent of each other - which is only true if the pursuit of short-term return does not compromise the ability to generate returns in the future by eroding capital, whether natural or man-made.⁶⁰ It also ignores the fact that an exclusive focus on short-term performance gives no incentive to manage risks which become material only in the longer term.

“A full appreciation of the duty of impartiality would require trustees to act for the long-term in order to ensure intergenerational equity between their youngest and oldest members”

Paul Abberley, CEO of Aviva Investors, has condemned the failure by pension investors to take account of the full range of risks that matter to young pension savers with a time horizon of decades rather than weeks:

“If you are investing in a company with a long-term horizon, it very much matters to know about sustainability issues, but if you are taking a time horizon of an average holding of six weeks, you might take the view that there may be a time bomb ticking but it is unlikely to go off in my holding period.”⁶¹

The lack of any official guidance on impartiality in an investment context is typical of the general paucity of authority on investors’ fiduciary obligations. While it is not suggested that a prescriptive ‘formula’ is what is needed - indeed, fiduciary obligation is all about the responsible exercise of trustees’ judgement - this does seem to be one area where guidance on the law could help both trustees and beneficiaries by providing a useful ‘nudge’ towards more long-term behaviours.

⁶⁰ Mansley, M. 2000, ‘Socially Responsible Investing: A Guide for Pension Funds and Institutional Investors’ (Monitor Press), p51-52 ⁶¹ Guardian, 4 Feb 2011, ‘Aviva chief attacks City for failure on sustainability’. www.guardian.co.uk/sustainable-business/aviva-chief-city-failure-sustainability

Chapter Summary

Investors do not have just one, monolithic ‘fiduciary duty’ but a number of distinct fiduciary *duties*, developed through centuries of case law and some legislation. There is significant confusion and disagreement over some fundamental issues such as the nature and purpose of fiduciary obligation, which investment agents are ‘fiduciaries’, and the nature and strictness of the duties they owe.

In particular, a full appreciation of the roots of fiduciary obligation does not support the commonly-held idea that an investor’s fiduciary duty begins and ends with maximising returns. Rather, fiduciary obligations exist to ensure that those entrusted to act on another’s behalf:

- act in the interests of beneficiaries and do not abuse their position to further their own interests or those of third parties (the duty of loyalty);
- and exercise due skill and care in the performance of their functions (the duty of prudence).

Current interpretations may be frustrating this purpose: in particular, the duty of loyalty has been subsumed into the duty of prudence, its distinctive importance neglected - particularly with regards to controlling conflicts of interest among the various agents to which trustees’ investment functions have been delegated.

In addition, the interpretation of the duty of prudence itself, which has too often become a ‘duty to herd’, exacerbates the reliance on short-term, benchmark-relative strategies and performance measures which may not be objectively serving beneficiaries’ interests.

In addition, just as fiduciary obligation evolved to take account of modern portfolio theory, so it now needs to adapt to the post-financial-crisis understanding of the importance of systemic risk. Further thought needs to be given to how fiduciary investors can ensure they are adequately protecting their beneficiaries from the full range of risks their capital is exposed to.

Summary of Recommendations

- **Government** should conduct a fundamental cross-departmental review of investors' fiduciary obligations, both to ensure that this valuable concept remains relevant in the 21st century, and to step back and reconsider whether the law is fulfilling its purpose of protecting beneficiaries. The goal should be to achieve enlightened fiduciary standards of care over all private pension savings and other long-term savings.
- A **cross-departmental group** should be established to carry forward the outcomes of this review and to act as a nexus for institutional investment issues within government.
- In particular, any **government** review should consider whether the existing legal framework is ill-equipped to deal with the problem of systemic risk, and should consider whether new law or guidance might be needed to ensure that trustees feel free to take account of systemic issues with implications for their members.
- As a minimum, **DWP** should issue a comprehensive guide for pension scheme trustees on their fiduciary duties in relation to exercising investment functions, setting out the key relevant obligations and providing guidance on their interpretation. This guidance could encompass many of the specific recommendations we make in subsequent chapters.



Chapter

The New Fiduciaries

Do fiduciary obligations extend
beyond trustees?

“There has been a shift from the traditional model [of capitalism] that applied when I grew up, in which the rewards of investing went primarily to those who put up the capital and who took the risks - to one where the spoils increasingly go to financial intermediaries¹”

Douglas Ferrans, Chairman, Investment Management Association

Financial markets today are vastly more complex than in the days when fiduciary obligations first developed. Between the ultimate owner of an investment and the investment itself stands a chain of intermediaries, who often have better information than the end investors and whose interests may not always be aligned with theirs. Commentators such as Paul Woolley of the LSE have argued that failing to recognise the existence of these agency relationships is a “*crucial flaw*” in conventional economic theory.² The UK Business Secretary, Vince Cable, recently highlighted the danger that returns can be “*captured by a small number of intermediaries at the expense of the many who provide the capital.*”³

This concern appears to be well-grounded in fact. From 2002-2007, pension funds’ payments to intermediaries rose by an estimated 50%,⁴ while annual real returns on pension investments averaged just 1.1%, significantly lower than preceding decades.⁵ A recent survey by Lane Clark & Peacock found little correlation between the level of fees charged by managers and the degree to which they outperformed the market. It also found that market performance rather than manager skill was the main driver of fee increases in 2010, such that an equity manager who underperformed the market by 2% could still expect a 20% increase in fees. The report found that even performance-related fee bases were “*skewed in the managers’ favour*”, doing little in practice to align managers’ interests with those of trustees and beneficiaries.⁶

“ From 2002-2007, pension funds’ payments to intermediaries rose by an estimated 50%, while annual real returns on pension investments averaged just 1.1% ”

Fiduciary obligation is predicated on a fairly simple bilateral relationship between beneficiary and trustee: the trustee is charged with looking after the beneficiary’s assets, and exercises discretion over how they are managed. This model worked for the private trusts of the nineteenth century - but how does it apply to today’s complex web of relationships, where most pension scheme trustees delegate day-to-day investment decisions to external asset managers and rely heavily on advice from consultants? If the actors exercising fiduciary responsibilities are no longer those making many of the key decisions affecting beneficiaries, the effectiveness of fiduciary accountability is undermined. Moreover, with the shift to contract-based pension arrangements provided by insurance companies, where there are no trustees at all, an increasing proportion of UK pension assets are passing out of the fiduciary sphere altogether.

² Woolley, P. ‘Why are financial markets so inefficient and exploitative - and a suggested remedy’, in LSE, 2010, ‘The Future of Finance’, p121-143 (online), 105-129 (hard copy); see in particular pages 125-126 and 128 (online), pages 109-110 and 113 (hard copy) ³ Vince Cable, Foreword to BIS, 2010, ‘A long-term focus for corporate Britain’. ⁴ Watson Wyatt, 2008, ‘Defining Moments: The Pensions & Investment Industry of the Future’. ⁵ Woolley, P. 2010: p135 (online), p121 (hard copy). Real returns averaged 4.1% for the whole of the period from 1963-2009 ⁶ Lane Clark & Peacock, 2011, ‘LCP Investment Management Fees Survey’

“ If the actors exercising fiduciary responsibilities are no longer those making many of the key decisions affecting beneficiaries, the effectiveness of fiduciary accountability is undermined ”

This chapter will suggest that these changes do indeed have profound implications for fiduciary relationships, which the legal framework has not yet adapted to. But it also concludes that the core principles of fiduciary obligation, far from being rendered obsolete by these changes, are perhaps more relevant than ever. In particular, the duty of loyalty, with its emphasis on avoiding conflicts of interest, speaks directly to the agency problems that policymakers and market participants are grappling with.

There are many actors in and around the investment chain: brokers, actuaries, lawyers, company directors, investment bankers, custodian banks, and so on. In this chapter we restrict our analysis to those agents immediately involved in the key investment decisions made on behalf of beneficiaries - namely, asset managers and investment consultants. We also consider the role of contract-based providers, asking how we can ensure that the quality of provision and legal protection is consistent across the market.

Why fiduciary obligations?

If the fiduciary relationship no longer corresponds with the way investments are managed, is it simply a relic that should be discarded? Trustees have contractual relationships with their asset managers, as do individual pension savers with their insurance companies. What do fiduciary obligations add to these contractual rights?⁷

Characteristics of the fiduciary relationship

As we saw in chapter 1, definitions of when a fiduciary relationship arises tend to coalesce around some or all of the following three factors:

- The exercise of discretion over another's assets
- A relationship of trust and confidence
- Vulnerability or dependency on the part of the beneficiary

The last of these is particularly interesting in the context of the investment chain. Principals are vulnerable in relation to their investment agents because the latter have better information and are therefore in a position to exploit their position at the principal's expense.⁸ Fiduciary obligation's emphasis on vulnerability and power imbalances is highly significant in this respect.

⁷ It is notable that the courts have confirmed that express or implied contractual terms can limit the scope of fiduciary obligations which would otherwise exist (*Kelly v Cooper* [1993] AC 205). The use of 'contractual techniques' to limit fiduciary liability is an example of conduct which, although not expressly prohibited by FSA rules, might be regarded as poor professional practice on the part of investment agents. ⁸ See for example Woolley, P. 2010, *op cit*

Duties

As we shall see, it is also important to go beyond the fiduciary label and disaggregate the different obligations it entails (see Chapter 1). Some of these may be more distinctive than others when compared with contractual obligations, and indeed may be more or less appropriate to apply to commercial actors. As a US court once noted:

*“To say that a man is a fiduciary only begins analysis; it gives direction to further enquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?”*⁹

A particular distinction needs to be drawn between the duty of prudence and the duty of loyalty (see Chapter 1). The duty of prudence is essentially a duty of care arising from the exercise of discretion over another’s assets. It protects beneficiaries from *external* risks - for instance, by requiring agents to act prudently and ensure they are investing appropriately for the client’s risk profile. On the other hand, the duty of loyalty - the strict duty to act in good faith and avoid conflicts of interest - protects beneficiaries from risks *created by the fiduciaries themselves*.¹⁰ It is designed to prevent fiduciaries from profiting at the expense of vulnerable or disempowered beneficiaries by exploiting their superior knowledge and power for personal gain.

This duty, described by the courts as the “*distinguishing obligation of a fiduciary*”,¹¹ goes to the heart of the differences between fiduciary and contractual duties. Commercial investment agents are governed by FSA rules (see Box A) and by the terms of their contracts with clients. These create a duty of care to the client which in practice is somewhat similar to the fiduciary duty of prudence. By contrast, commercial duties to put clients’ interests first and to avoid conflicts are much less strict than the fiduciary duty of loyalty.

“ The act of putting aside one’s personal interests and doing what is best for the beneficiary is essential to the notion of a fiduciary ”

⁹ *SEC v Chenery Corp* 518 US 80 (1943), at 85-86 per Frankfurter J, cited by the Privy Council in *Re Goldthorp Exchanges Ltd* [1994] 2 All ER 806. See Pearce, Stevens & Barr, 2010, ‘*The Law of Trusts and Equitable Obligations*’, 5 ed. (Oxford University Press), p910. ¹⁰ We are grateful to David Howarth of Cambridge University for this characterisation of the distinction. ¹¹ *Bristol and West Building Society v Mothew* [1996] 4 All ER 698 ¹² *Re Whiteley* [1886] LR 33 Ch D 347

Box A: Fiduciary obligations and regulatory rules

Fiduciary obligations (case law)

Prudence:

“The duty of a trustee is ... to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide.”¹²

(Re Whiteley)

Loyalty

“The principal is entitled to the single-minded loyalty of his fiduciary. This core liability has several facets: a fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal.”

(Bristol and West Building Society v Mothew)

FSA Principles

A firm must conduct its business with due skill, care and diligence. (Principle 2)

A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment. (Principle 9)

A firm must arrange adequate protection for customers’ assets when it is responsible for them (Principle 10)

A firm must conduct its business with integrity. (Principle 1)

A firm must pay due regard to the interests of its customers and treat them fairly. (Principle 6)

A firm must manage conflicts of interest fairly, both between itself and its customers and between one customer and another. (Principle 8)

The FSA requires firms to “pay due regard to the interests of [their] customers”, and the Conduct of Business Sourcebook (COBS) elaborates the ‘client’s best interest rule’, stating that “A firm must act honestly, fairly and professionally in accordance with the best interests of its client.”¹³ Firms must also disclose their conflicts of interest policy to retail clients on request. Yet this seems to stop short of the “single-minded loyalty” described in Bristol and West Building Society v

Mothew. In a 1995 report on fiduciary obligations and regulatory rules, the Law Commission noted that the duty to ensure ‘fair treatment’ of customers is a lower standard than the fiduciary obligation to put customers first,¹⁴ and that “there are many instances where regulatory rules permit... a lower standard of conduct than that required by fiduciary law.”¹⁵

¹³ FSA, Conduct of Business Sourcebook, 2.1.1 ¹⁴ Law Commission, 1992, ‘Consultation Paper No. 124: Fiduciary Duties and Regulatory Rules’ (HMSO), paras 4.3.4 & 4.4.2 ¹⁵ Law Commission, 1995, ‘Fiduciary Duties and Regulatory Rules’, (HMSO), para 1.8

The act of putting aside one's personal interests and doing what is best for the beneficiary is essential to the notion of a fiduciary. Again, this core aspect of fiduciary obligation is particularly relevant to current debates about the status of investment agents, which focus precisely on how to ensure that agents are not able to capture gains at beneficiaries' expense.

Remedies

The fundamental principle that fiduciaries may not take advantage of their position for personal gain forbids them not only from profiting at beneficiaries' expense, but also from deriving any unauthorised profit from their fiduciary position, whether or not their beneficiaries suffer any loss.¹⁶ The legal remedy for breach of fiduciary obligation is restitution or disgorgement - the fiduciary must give back any profit derived from the breach. This remedy is more onerous than restoration (where the offender must 'restore' the situation as it was before they committed the breach) or compensation (where the offender must compensate the victim for any loss they suffered). Both of these latter remedies leave open the possibility of 'efficient breach', where the breach of duty still benefits the offender even after the remedy has been exacted (for instance, where a breach of contract allows them to enter into a new and more profitable contract).¹⁷ By definition, this is not permitted in the context of fiduciary obligations. Again, this is highly relevant in the context of the investment chain. Paul Woolley observes that "*managers have limited liability either in the legal sense or because the pattern of pay-offs enables*

“ Although traditional fiduciary structures may have been left behind by the changing world of investment, the underlying concept remains as relevant as ever ”

them to participate in gains but to suffer no losses."¹⁸ Thus, unduly risky behaviour can be profitable even if the interests of ultimate owners are compromised.

As Woolley concludes, "*the combination of opacity and moral hazard is the nub of the agency problem.*"¹⁹ Fiduciary obligation speaks to both these problems, and provides protection against them which materially exceeds that offered by regulatory rules and contractual rights. Although traditional fiduciary structures may have been left behind by the changing world of investment, the underlying concept remains as relevant as ever.

Achieving fiduciary standards in practice

The next question, then, is how these concepts can be applied to today's very different marketplace. Based on the characteristics of fiduciary relationships discussed above, there appears to be a strong prima facie case for regarding anyone on whom savers rely for the management of their money as a fiduciary. Indeed, this view appears to be supported by the Law Commission, which concluded

*“It is evident that in general a firm advising a customer or making purchases on a customer’s behalf will be acting in a fiduciary capacity.”*²⁰ But the analysis cannot stop at whether a particular agent is a fiduciary: it is vital to ask how fiduciary standards of care can be achieved in practice. Indeed, even where commercial agents already describe themselves as fiduciaries (e.g. UK asset managers) or are regarded as such by law (e.g. US investment consultants), it is questionable whether these standards are truly being met - particularly when it comes to the distinguishing fiduciary duty of loyalty.

Conflicts of interest and the duty of loyalty

The reality of a commercial investment firm has the potential to create innumerable conflicts - between the firm’s shareholders and its clients, between one set of clients and another, between one part of the firm and another - which are not easily resolved. This is not to say that it is impossible for fiduciary duties to apply in any commercial context: the law increasingly recognises that remunerating trustees may further beneficiaries’ interests, and there are examples where the status of fiduciary and commercial actor coincide, such as firms of lawyers or trustee corporations.²¹ But it is difficult to reconcile the strict standards expected of fiduciaries with the sharply divergent fortunes of savers and their intermediaries seen in recent years - or with the conflicts of interest which, in the aftermath of the financial crisis, are increasingly recognised as a key governance challenge.

Addressing conflicts of interest

The potential for conflicts of interest to arise in financial services was significantly increased by the ‘Big Bang’ deregulation, which allowed the development of large conglomerates combining various different services (e.g. asset management and investment banking).²² Conflicts of interest received much attention from legislators and regulators after the dotcom bubble burst,²³ and more recently in the aftermath of the financial crisis. There is a wide spectrum of possible approaches to the problem, from ensuring that clients are made aware of actual or potential conflicts, to encouraging or requiring firms to have procedures for identifying and managing conflicts, to structurally eliminating conflicts altogether by banning activities which give rise to them.²⁴ In contrast to some other jurisdictions, the approach of UK regulators has historically been light-touch, with emphasis on a principles-based approach and on dialogue with the industry rather than on detailed rules and regulations.²⁵ FSA rules do include requirements to manage and disclose conflicts of interest - including some imposed by European law under ‘MiFID’²⁶ - but these are less stringent than fiduciary duties.

“ One of the things that distinguishes fiduciary obligation is that it requires conflicts to be not just managed but, as a general rule, avoided ”

²⁰ Law Commission, 1992, *op cit*, para 2.47 ²¹ The case of law firms may also provide a useful model for resolving practical questions about where liability would rest if fiduciary duties were extended to commercial investment agents and pension providers. Individual lawyers are fiduciaries and therefore are obliged to act as such, but liability for any damages consequent upon breach of that obligation rests with the firm. A similar principle would seem appropriate in the investment sphere. ²² See Law Commission, 1995, *op cit*, p1-2 ²³ Clark, K. (ed.), 2005/06, ‘Conflicts of interest: Jurisdictional comparisons in the law and regulation for the financial services, auditing and legal professions’, European Lawyer Reference, p iv-v ²⁴ For a discussion of this see Law Commission, 1992, *op cit*, paras 4.1-4.4 ²⁵ Clark, K. (ed.), 2005/06, *op cit*, p vii, p44 ²⁶ European Directive 2004/39/EC, ‘Markets in Financial Instruments Directive’, Articles 13(3) and 18

One of the things that distinguishes fiduciary obligation from the regulations governing investment agents at large is that it requires conflicts to be not just managed but, as a general rule, *avoided*.²⁷ In his inaugural speech as Chairman of the IMA, Douglas Ferrans did not shy away from the implications of this for asset managers:

*“We have to act responsibly, and where necessary inform our conflicted parents of our fiduciary duty to our customers. If they don’t like it, it is clear they should divest themselves of their asset management businesses and only then can the conflicts be conquered and the behaviours altered!”*²⁸

This raises an important wider point: in any review of the application of fiduciary duties to commercial investment agents, existing practices or organisational structures must not be regarded as sacrosanct. It may be concluded that a firm’s proprietary trading is inconsistent with its having fiduciary duties to its clients, or that Chinese walls within a firm are insufficient to ensure fiduciary standards are met. This should not automatically lead to the conclusion that fiduciary obligations must fall by the wayside. Rather, if fiduciary standards of care are judged to be important for the protection of savers, it may be necessary to structurally eliminate these conflicts - whether by regulatory changes to the aggregations of services permitted within a single entity, or by encouraging alternative business models such as financial mutuals.

In an essay written before the financial crisis, Sir Howard Davies, former Chairman of the FSA, concluded that such solutions could generally only be found *“at unacceptable cost”*, and that transparency was therefore the most effective response to conflicts of interest in the financial markets, with the onus on investors and customers to act on the information disclosed. However, he also acknowledged that in some cases this might not be a realistic expectation, and explicitly highlighted pension savings as one such case: *“in these circumstances, there is little that investors can do by way of withholding their business, and, by the time the effect of this conflict is evident, it is likely to be too late for investors to act.”*²⁹ Arguably, fiduciary obligations exist precisely to protect people who find themselves in this situation. If fiduciary standards of care are truly to be achieved in practice, it is vital that no solutions are treated as being ‘off-limits’ - even those with far-reaching implications for the business models of pension providers and their agents.

“If fiduciary standards of care are truly to be achieved in practice, it is vital that no solutions are treated as being ‘off-limits’”

²⁷ Clark, K. (ed.) 2005/06, *op cit*, p46 ²⁸ Douglas Ferrans, Wednesday 9 June 2010, Speech to IMA Annual Dinner

²⁹ Sir Howard Davies, ‘Conflicts of Interest for banks, auditors and law firms,’ in Clark (ed.) 2005/06, *op cit*

Below we examine whether and how fiduciary obligations currently apply to trustees' key agents - asset managers and investment consultants - comparing this with other jurisdictions and asking whether the current position is adequate. We also consider the implications of this increased delegation for trustees themselves. Finally, we explore the situation for contract-based pension provision, in which there are no trustees at all. Throughout we give particular consideration to conflicts of interest.

Asset managers

The legal position

External asset managers are increasingly responsible for many of the day-to-day investment decisions formerly undertaken by trustees. Yet there is no definitive legal authority on the question of whether this assumption of responsibility makes asset managers fiduciaries in their own right.

It has sometimes been argued, for example in the Freshfields Report (see Chapter 3), that *"fiduciary duties do not apply directly to fund managers or investment consultants in typical circumstances, because they do not act as custodians of fund assets in the way that trustees do."*³⁰ But others hold that discretionary investment managers are fiduciaries,³¹ since *"the client has an expectation that the institution will place the client's interest above the interests of the institution."*³² This was certainly the view taken by the Law Commission in the paper that preceded its 1995 report.³³ We believe this argument has considerable force. Asset managers exercise control over beneficiaries' interests in circumstances which make the beneficiaries heavily dependent on their skill and good faith.

Based on the criteria discussed above, there are strong grounds to believe that this relationship is a fiduciary one, and that this would be confirmed were the issue to be tested in court. Asset managers are also regarded as fiduciaries in some other jurisdictions, such as the United States (see Box B).

“Asset managers exercise control over beneficiaries' interests in circumstances which make the beneficiaries heavily dependent on their skill and good faith”

Even if asset managers are not fiduciaries in their own right, the Freshfields report concludes that they *"are often effectively subject to the same obligations as trustees regarding their decision-making"*³⁴, through legislation, the law of negligence or their contractual relationships with trustees. For example, fund managers exercising delegated investment powers for trustees are required by UK law to comply with the same regulations as trustees,³⁵ including requirements to have regard to the need for diversification and to act in beneficiaries' best interests.³⁶ But this does not have quite the same effect as the asset managers being treated as fiduciaries in their own right under common law. As discussed above, the remedies for breach of duty are quite different. In addition, under contract the asset manager's duty remains to the trustees only, since the manager has no contractual relationship with the beneficiaries directly.

³⁰ UNEP FI, 2005, 'A legal framework for the integration of environmental, social and governance issues into institutional investment,' p85 ³¹ See for example S Willey, 'Investment Management and fiduciary duties', in *Law and Regulation of Investment Management* [full citation in Freshfields], p237 ³² Keith Clark (ed.), 2005/2006, *op cit*, p iv ³³ Law Commission, 1992, *op cit*, paras 2.4.7 & 2.4.14 ³⁴ UNEP FI 2005, *op cit*, p85 ³⁵ Pensions Act 1995, s36 as amended by Pensions Act 2004, s245 ³⁶ The Occupational Pension Schemes (Investment) Regulations 2005, SI 2005/3378, regulations 4(2) and 4(7)

The division of responsibilities between trustee and asset manager is not entirely clear. The Pensions Act 1995 states that trustees cannot limit their own liability for breach of their duty of care by delegating to asset managers.³⁷ Trustees will only avoid liability for fund managers' actions if they (or the person who appointed the manager on their behalf) have taken all reasonable steps to satisfy themselves that the manager has the appropriate knowledge and experience, and is carrying out his work competently.³⁸ In other words, trustees can delegate their powers, but not their fiduciary responsibilities. As the Freshfields Report notes, this issue has not yet been tested in the courts;³⁹ there has also been no official guidance on its practical application. This means there is considerable uncertainty over where the trustee's responsibilities end and the asset manager's begin. This is explored further on pages 45-46.

Box B: International comparisons - the United States

In the United States, ERISA explicitly states that fiduciary liability attaches not only to trustees but also to anyone exercising discretion over plan assets. As such, asset managers have direct fiduciary obligations, and the appointment of asset managers is itself a fiduciary function.⁴⁰

The situation in practice

Asset managers routinely describe themselves as 'fiduciaries', and the Chairman of the Investment Management Association (IMA) has also used this term.⁴¹ But does this entail a sophisticated understanding of the various common-law fiduciary duties, such as loyalty, impartiality and prudence, or is it simply a byword for a duty of care to clients? At our second seminar, one former fund manager said,

"There was an idea that you had to understand your clients' attitude to risk, and you had to make sure that the portfolios were managed in a way that was consistent with that attitude to risk."

Yet this duty is articulated in FSA regulations⁴² and applies to all financial intermediaries. As discussed above, it stops well short of the strict duty of loyalty demanded of fiduciaries. Asset managers generally do not appear to regard their 'fiduciary' status as requiring them to 'put their clients first' at all times. For instance, the chairman of a major UK asset manager was recently quoted as saying "*what matters most are the best interests of [the firm], its shareholders, its staff and its other stakeholders.*"⁴³ It is interesting to note that the best interests of clients and their ultimate beneficiaries are not given any explicit priority in this list. Likewise, the minimal nature of some asset managers' disclosures under the Stewardship Code regarding conflicts of interest (see below) jars somewhat with the self-description of many asset managers as 'fiduciaries', suggesting that this may not always entail a sophisticated understanding of the distinguishing fiduciary duty of loyalty.

³⁷ Pensions Act 1995: Section 33(1) ³⁸ Pensions Act 1995: Section 34(4) ³⁹ UNEP FI 2005, *op cit*, p84 ⁴⁰ ERISA § 3(38), 29 USC § 1002(38), cited in UNEP-FI, 2005, *op cit*, pp107-108 ⁴¹ Douglas Ferrans, Wednesday 9 June 2010, Speech to IMA Annual Dinner ⁴² FSA, Principles for Businesses: Principle 9 ⁴³ Responsible Investor, 3 Feb 2011, 'Corporate governance and sustainability specialist loses support for board control'

Conflicts of interest

Douglas Ferrans has suggested that the industry should do more to “*challeng[e] the excessive intermediation that is creeping into the system... [which] often manifests itself in conflicts of interest which clearly act against our customers’ interests.*”⁴⁴ Referring to asset managers as fiduciaries, he implicitly acknowledged that the industry was failing to fulfil its fiduciary responsibilities, saying that agents had too often “*unwittingly placed their own interests ahead of those of their clients.*”⁴⁵

For instance, many asset management firms are owned by banks and insurance companies who have their own business relationships with investee companies, often commercially more significant to the parent company than the interests of its asset management arm. This may unduly influence asset managers’ decisions, or discourage them from speaking out about poor corporate governance.

Principle 2 of the UK Stewardship Code requires institutional investors to have a ‘robust policy’ for managing conflicts of interest: the guidance states

*“An institutional investor’s duty is to act in the interests of all clients and/or beneficiaries when considering matters such as engagement and voting. Conflicts of interest will inevitably arise from time to time, which may include when voting on matters affecting a parent company or client.”*⁴⁶

Yet, when FairPensions conducted a survey of asset managers’ disclosures under the Stewardship Code, conflicts of interest policies were one of the weakest areas of disclosure. Less than a third of asset managers provided what the researchers considered a ‘robust’ conflicts of interest policy; some restricted disclosure to a generic statement that any conflicts would be resolved in the interests of the shareholding client, without any indication of how this was to be achieved.⁴⁷ Conflicts policies should be detailed and meaningful (see Box C), and dynamic rather than static, allowing for the impact of new products and structures. It would be helpful for the FRC to emphasise the importance of managing conflicts of interest in future work on the Stewardship Code, and to remind asset managers of its relevance to the fulfilment of their fiduciary duties.

“*When FairPensions conducted a survey of asset managers’ disclosures under the Stewardship Code, conflicts of interest policies were one of the weakest areas*”

⁴⁴ Douglas Ferrans, Wednesday 9 June 2010, Speech to IMA Annual Dinner, p3 ⁴⁵ *ibid*, p4 ⁴⁶ FRC, 2010, ‘The UK Stewardship Code’, p5 ⁴⁷ FairPensions, 2010, ‘Stewardship in the Spotlight,’ p9

Box C: Key elements of a conflicts policy

- Specifies specific ways in which a conflict may arise in the particular organisation
- Specifies the procedures in place for managing such conflicts to include:
 - rules on gifts and entertainment
 - internal staff training on conflicts of interest
 - maintenance of conflicts register
 - procedure for the voting of shares held in the manager's parent company
 - rules on personal share dealing by staff
- Chinese Walls and other procedures to control the exchange of information

(Source: *FairPensions, 2010, 'Stewardship in the Spotlight'*)

Recommendation: *The FSA/FCA should remind asset managers of their fiduciary status and of the fact that this may entail stricter obligations than those imposed by regulatory rules. It should also seek to improve firms' understanding and application of fiduciary obligations, with a particular focus on the prevention, management and disclosure of conflicts of interest.*

Investment consultants

The legal position

Investment consultants are clearly in a slightly different position from asset managers since, while asset managers exercise direct discretion over beneficiaries' assets, consultants merely advise. At first glance, the case for extending any sort of fiduciary obligation to investment consultants would therefore seem less strong. Yet fiduciary duty need not only arise when someone has been entrusted with another's assets, but in any situation where they are entrusted with their *interests*, or directed to act on their behalf (see Chapter 1).

Some of the arguments about consultants' duties - for instance, the extent to which they have indirect duties by virtue of their contracts with trustees - are similar to those for asset managers. The fiduciary obligation remains firmly with the trustees who must still exercise their own judgement based on the advice received - the courts are clear that trustees may not simply 'outsource' their judgement to advisors.⁴⁸ Once again, there is little explicit authority on whether consultants have fiduciary duties in their own right - although the Law Commission appears to take the view that giving investment advice is a fiduciary function.⁴⁹

“ *Fiduciary duty need not only arise when someone has been entrusted with another's assets, but in any situation where they are entrusted with their interests* ”

⁴⁸ See for example *Martin v City of Edinburgh District Council*, 1988 SLT 329, 1988 SCLR 90 ⁴⁹ Law Commission, 1992, *op cit*, para 2.4.7 and 2.4.14

In addition, the relationship between trustees and investment consultants would seem to fulfil the criteria of vulnerability and dependence which have been said to characterise the fiduciary relationship. Pension trustees are under a statutory obligation to obtain and consider the written advice of investment consultants when preparing or revising their Statement of Investment Principles.⁵⁰ Their duty of prudence will also normally require them to take advice in connection with other key functions, such as the selection and monitoring of fund managers. As the Myners Report observed, trustees *“do not in general seem to be drawn from the ranks of those experienced in investment”* and as a result *“rely heavily on professional advice.”*⁵¹ Moreover, they are reliant on a relatively small pool of authorised firms, which potentially renders them more vulnerable.⁵²

A decade later, these observations still hold. Where trustees are not in a position to challenge the recommendation of their investment consultants, those consultants wield enormous influence over the exercise of trustees’ powers of investment. As such, they could be said to be exercising fiduciary functions. Indeed, the relationship between investment advisor and client is already recognised as a fiduciary one in the United States (see Box D). Many of the largest UK consulting firms are subsidiaries of US companies; the legal implications of this for their fiduciary status have yet to be fully considered.

“Where trustees are not in a position to challenge the recommendation of their investment consultants, those consultants wield enormous influence”

⁵⁰ The Occupational Pension Schemes (Investment) Regulations 2005, SI 2005/3378, regulation 2(2) ⁵¹ Myners, P. 2000, *‘Institutional investment: A consultation paper’* (HM Treasury), p4 ⁵² Myners, P. 2001, *‘Institutional investment in the United Kingdom: A review’* (HM Treasury), paras 29-33

Box D: International comparisons - the United States

In the US, it is generally accepted that investment consultants are fiduciaries under the Investment Advisers Act 1940. Although the Act does not explicitly use the term 'fiduciary', the Supreme Court has held that it reflects "*the delicate fiduciary nature of an investment advisory relationship*", and was intended to "*eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser - consciously or unconsciously - to render advice which was not disinterested.*"⁵³ More recently, the North American Securities Administrators Association has recommended the extension of fiduciary duties to all those offering investment advice, including broker-dealers.⁵⁴

The SEC focuses on ensuring that any conflicts of interest are clearly exposed to clients (for instance, if an advisor recommends securities in which he has a proprietary interest), that potential conflicts are identified and managed internally, and that advisors always act in the utmost good faith according to what is best for their client.

Yet, in a 2006 speech to the industry, Lori Richards of the SEC expressed concern that "*the application of fiduciary duty is not as embedded in many firms' cultures as it could be ... I'm far from certain that all advisory firms understand their fiduciary obligations, and how they apply in the context of their own operations.*"⁵⁵ Richards went on to stress the importance of the identification, disclosure and management of conflicts of interest.

Thus, the US experience confirms that it is possible to extend fiduciary obligations to investment consultants - but it also confirms the need to go beyond the fiduciary label. Extending fiduciary obligations will not, by itself, necessarily lead to higher standards of care. Prevailing industry culture and enforcement of legal duties are both crucial in this respect.

⁵³ SEC v Capital Gains Research Bureau, Inc 375 U.S. 180 ⁵⁴ North American Securities Administrators Association, 2 Feb 2011, '*NASAA's Pro-Investor Legislative Agenda for the 112th Congress*', p3, available at www.nasaa.org/content/Files/2011_Legislative_Agenda.pdf ⁵⁵ Lori A Richards, February 27, 2006, '*Fiduciary Duty: Return to First Principles*' (Speech to Eighth Annual Investment Adviser Compliance Summit)

The situation in practice

Unlike asset managers, UK investment consultants do not generally appear to regard themselves as fiduciaries. This perhaps reflects the general preoccupation with the duty of prudence arising from control over someone's *assets*, as opposed to the duty of loyalty arising from control over their *interests*.

The nature of the fiduciary relationship encourages a sense that trustees remain in the driving seat. This is problematic when trustees are heavily reliant on consultants' advice due to their greater expertise: again, the site of obligation does not match the site of decision-making, which potentially leaves a vacuum of responsibility. This may pose particular problems for smaller schemes, who are often forced to rely on commoditised investment advice and receive a lower standard of care than larger clients. They may also be less able to challenge the advice they receive. A recent OECD paper expressed concern that small schemes *"may be more exposed to conflicts of interest and be at the mercy of consultants and external advisors who may lead them to make risky investments that they may not fully understand."*⁵⁶ The confirmation of direct fiduciary obligations on consultants might offer some protection for trustees who are in a weak position to ensure the good faith and diligence of their advisors in other ways.

Conflicts of interest

There is ample scope in practice for an investment consultant's duty to act in the best interests of their client to come into conflict with their interests. For instance, it may not always be in consultants' interests to help schemes control costs; on the contrary, they may well benefit from recommending more complex investment approaches and services than are really necessary or suitable for the scheme in question. There is evidence that pension schemes' investment approaches have become significantly more complex in recent years - for example, the average externally managed pension scheme has nine mandates, compared to just three a decade ago.⁵⁷ This trend has cost pension funds up to a third extra in management fees, and has also increased the fees paid to consultants due to the higher number of manager selection processes.⁵⁸ It is questionable whether this increased complexity has been value for money in terms of improved performance.

Recommendation: *The FSA/FCA should confirm that investment consultants are fiduciaries in relation to their clients and should work to ensure that these obligations are understood and applied in practice, with a particular focus on the prevention, management and disclosure of conflicts of interest.*

⁵⁶ Stewart, F. and J. Yermo (2008), 'Pension Fund Governance: Challenges and Potential Solutions', OECD Working Papers on Insurance and Private Pensions, No. 18, OECD publishing; p13 ⁵⁷ The WM Company, 2010, cited in Lane Clark & Peacock, 2011, Investment Management Fees Survey, p13. ⁵⁸ Ibid, p14

Box E: Small schemes

Aside from their reliance on commoditised advice, smaller schemes and their members may suffer from various other disadvantages compared to larger schemes. For instance, they may receive less full reporting from their asset managers or be told that their fees are insufficient for the asset manager to engage with companies on their behalf; they will be more likely to invest in pooled funds, thereby losing rights to instruct on how their shares should be voted; and they cannot take advantage of economies of scale, resulting in higher per member unit costs.

Costs per member of scheme administration have been shown to be more than twice as high for schemes with less than 2,000 members as for those with more than 10,000 members.⁵⁹ Recent DWP research found that the mean annual cost of employing asset managers was £96 per member for schemes with less than 100 members and £59 for those with more than 10,000 members; independent financial advisors

were over eleven times more expensive per member for the smallest schemes compared to the largest.⁶⁰ In addition, as recently noted by The Pensions Regulator, “*survey evidence suggests that the smallest schemes are less likely to benefit from good governance.*”⁶¹

In 2010 there were 44,000 DC schemes with less than 12 members. These schemes accounted for over 90% of all schemes but just 5% of all members.⁶² Given the governance challenges and higher costs faced by these schemes, it is difficult to see how their trustees are truly able to act in members’ best interests. In addition, a smaller number of larger schemes would clearly find it easier to devote resources to good quality member engagement and communication (see Chapter 5).

Recommendation: *Small pension schemes should be encouraged and enabled to consolidate, bearing in mind the per member unit costs of running small schemes and the generally higher quality of scheme governance and member communications in larger schemes.*

“ Trustees exist not just to make sensible investment decisions but to single-mindedly champion and defend beneficiaries’ interests ”

⁵⁹ Capita Hartshead, 2010, 17th Annual Pensions Scheme Administration Survey. ⁶⁰ DWP, 2010, ‘Working Paper 91, Pension Scheme Administration Costs’, p6 ⁶¹ TPR, February 2011, ‘Enabling good member outcomes in work-based pension provision’, para 11 (p7) ⁶² TPR, 2010, ‘DC Trust: A presentation of scheme return data’, p 4

Implications for trustees

It is often suggested that investment agents have less stringent duties to ‘sophisticated’ institutional investors than to ‘unsophisticated’ private individuals. Yet, as we have seen, the relationship between trustees and their agents shares some of the features of that between beneficiary and trustee - particularly in relation to the key fiduciary characteristic of dependency. This problem was identified by Lord Myners ten years ago, leading to an intensified focus on trustee knowledge and understanding. Others have responded to this challenge by turning to ‘fiduciary management’ (see Box F). But this raises deeper questions about the value added by trustee oversight.

The answer to such questions perhaps lies once again in the duty of loyalty. The trustee is ideally an unconflicted individual who owes a duty of undivided loyalty to the beneficiaries. This is not to say that trustees themselves are always free from conflicts: employer-nominated trustees often face conflicts when a decision must be taken which affects the sponsoring employer; likewise, member-nominated trustees may face conflicts in relation to their duty of impartiality, being predisposed to favour beneficiaries of a similar age and gender to themselves.⁶³ The Pensions Regulator has devoted significant attention to ensuring that these conflicts are properly managed,⁶⁴ and acknowledges there may be more to do.⁶⁵ Having said this, most trustees are largely free of conflicts in relation specifically to their *investment* functions. In this regard, trustees exist not just to make sensible investment decisions but

to single-mindedly champion and defend beneficiaries’ interests in a way that a commercial investment agent, however well-intentioned, may be unable to do.

Box F: Fiduciary management

The term ‘fiduciary management’ is used to refer to a range of approaches involving the delegation or outsourcing of day-to-day scheme management, including asset allocation. The approach originated in the Netherlands in the early 2000s, and has been generating increasing international interest: total UK pension fund assets run under fiduciary management have been predicted to more than double to £35bn (3.8%) by the end of 2011.⁶⁶ Concerns have been raised, including by the OECD, that *“it is unclear whether commercial providers can manage the conflicts of interest inherent to such activities.”*⁶⁷ More recently there has been some debate over the utility of the term, including suggestions that the ‘first wave’ of fiduciary management, where too much was delegated to managers, has been superseded by a new model focussing more on transparency and good governance.⁶⁸ Yet the term itself highlights the challenges this trend presents for the fiduciary framework: trustees are delegating more and more of their traditional fiduciary functions to actors who do not share their fiduciary responsibilities.

⁶³ Stewart, F. and J. Yermo, 2008, *op cit*, p25 ⁶⁴ See for example TPR, 2007, ‘Governance of work-based pension schemes’ ⁶⁵ www.thepensionsregulator.gov.uk/guidance/guidance-conflicts-of-interest.aspx, accessed on 24 Feb 2011 ⁶⁶ Pensions Week, 7 Feb 2011 (No. 688), ‘Fiduciary assets to rise twofold in 2011’. ⁶⁷ Stewart, F. and J. Yermo, 2008, *op cit* ⁶⁸ See for example IPE, 10 Feb 2011, ‘German investors ‘misunderstand’ fiduciary management’; 23 Feb 2011, ‘Ambiguity of fiduciary management borders on ‘ridiculous’, consultants say’

Scrutinising and monitoring investment agents is therefore absolutely central to the continuing role and value of trustees in the twenty-first century. Indeed, The Pensions Act 1995 makes clear that, in order to fulfil their duty, trustees must monitor their managers on an ongoing basis.⁶⁹ Most trustees undoubtedly do see their fiduciary role in these terms. However, there does appear to be a perception in some quarters that receiving quarterly performance reports is sufficient to fulfil this responsibility. It is a common experience for pension fund members who contact their trustees about an investment issue to be told simply that such decisions are delegated to fund managers, as if the trustees have thereby washed their hands of the matter. Some fund members have even been told that trustees' duty prohibits them from interfering with their fund manager's discretion in response to members' concerns. Arguably, the reverse is true: trustees' fiduciary obligation consists precisely in continuing to ensure that fund managers are acting consistently in members' interests.

Knowledge and understanding of investment matters, while crucial to enabling trustees to play this role, is not the only factor. Some trustees present at our seminars felt that the training available to them was insufficiently focussed on the skills needed to monitor and challenge their asset managers when appropriate - and, indeed, that much of the training available was provided by agents who themselves had little interest in improving trustees' capacity in this area. Some also felt that member-nominated trustees (MNTs) were too often sidelined from investment decision-making and given insufficient support to play a

robust and challenging role. Just as the Walker Review considered the balance between independence and expertise on the boards of financial institutions,⁷⁰ so perhaps it is time to ask how the same balance can be achieved on the boards of pension schemes.

Recommendation: *Trustees should seek to avoid and manage conflicts of interest not just within the trustee board itself, but also among their service providers. In particular, funds should request information regarding the policies their asset managers and consultants have in place to ensure that specific relevant conflicts are properly managed.*

Recommendation: *TPR should take steps to ensure that the training available to trustees on the critical matter of monitoring asset managers is sufficiently robust and independent. There is also a role for trade unions in providing continued support for member-nominated trustees.*

“ Trustees’ fiduciary obligation consists precisely in continuing to ensure that fund managers are acting consistently in members’ interests ”

⁶⁹ Pensions Act 1995, Section 34(4). On this see also Scanlan, ‘Socially Responsible Investment by Charities and Pension Schemes’, Charity Law and Practice Review, Volume 9, Issue 1, 2006, p50 ⁷⁰ Walker, Sir D., 2009, ‘A review of corporate governance in UK banks and financial industry entities’

“An increasing proportion of pension savings are passing out of the fiduciary sphere altogether”

Contract-based pension providers

In 2009, while 3.3 million people were active members of trust-based occupational pension schemes, 3 million were members of contract-based workplace pension arrangements such as group personal pensions.⁷¹ These arrangements are provided by insurance companies and governed by contractual relationships with those companies: there are no trustees. This figure does not include the millions of people saving for their retirement as individuals rather than through their workplace, by purchasing pension products directly from insurance companies (individual personal pensions). Insurance companies are increasingly dominating UK pension provision, with trust-based schemes a dwindling proportion of the market: an increasing proportion of pension savings are therefore passing out of the fiduciary sphere altogether.

The arrival of NEST - which is expected to become the UK's largest pension scheme - does at least suggest that trust-based pensions will not disappear altogether. Nonetheless, the debate about pension funds' fiduciary obligations may soon become academic if it does not address this trend. There is also a danger that the split between trust-based and

contract-based provision creates a more or less arbitrary distinction between the protections enjoyed by one pension saver and the next, simply by virtue of the form of their pension arrangements (which are rarely under their control). This applies both to the *duties* to which providers are subject, and to the *structures* in place to ensure beneficiaries' interests are protected. It appears to be generally accepted that contract-based pension providers do not have fiduciary duties, either directly or indirectly.⁷² Savers are protected only by their contractual relationship with the provider and by the enforcement of FSA rules - which, as we have seen, are less stringent than fiduciary obligations. Meanwhile, the absence of trustees may lead to an accountability gap or 'governance vacuum': as a recent OECD paper put it, "*contract-based DC plans and personal pension arrangements are not usually run by a governing board that caters exclusively to the interest of members and beneficiaries.*"⁷³

This uneven legal framework has implications not just for insurance companies themselves, but for the agents who act on their behalf. For instance, if one takes the Freshfields view that the agents of trustees are contractually bound to uphold trustees' fiduciary duties but are not fiduciaries in their own right, an asset manager employed by an occupational pension scheme may be held to a higher standard of care than the same asset manager employed by an insurance company.

⁷¹ The Pensions Regulator, 2011, 'Enabling good member outcomes in work-based pension provision', p12 ⁷² See for example TPR, 2011, 'Enabling good member outcomes in work-based pension provision', p33 ⁷³ Stewart, F. and J. Yermo, 2008, *op cit*

This seems intuitively unfair. The basic relationship at work is the same for all forms of pension saving, whether trust- or contract-based: one person's assets are entrusted to another for the purpose of providing them an income in retirement. Insurance companies may see their individual personal pension products as nothing more than tax-efficient savings vehicles which should not subject them to any duties beyond the contract between provider and client. But here too, as with asset managers and consultants, the general characteristics of a fiduciary relationship - discretion, dependence and vulnerability - do seem to be present. Insurance companies undoubtedly fall under the category of those "advising a customer or making purchases on a customer's behalf" whom the Law Commission held to have fiduciary duties.⁷⁴ As such, there would seem to be a strong case for saying that the relationship between insurance company and pension saver is, in fact, a fiduciary one, and that fiduciary-like obligations should apply more consistently across the market. This is the situation in many countries where trusts do not exist as a legal form, including Spain,⁷⁵ Germany,⁷⁶ Italy⁷⁷ and South Africa (see Box G).

“The basic relationship at work is the same for all forms of pension saving, whether trust- or contract-based: one person's assets are entrusted to another for the purpose of providing them an income in retirement”

Box G: International comparisons - South Africa

In South Africa, pension funds are not established under trust but are legal persons in their own right. Save for a few specific exceptions, all South African pension funds are subject to the same legislative regime.

This contrasts with the UK position whereby occupational and personal pensions have different legal status, are subject to different legislation and are overseen by different regulators.

All pension funds are required by statute to have a board of members whose object is to administer the fund and whose role is similar to that of trustees in the UK. These board members are required by legislation to:

- take all reasonable steps to ensure that the interests of members are protected;
- act with due care, diligence, skill and faith;
- avoid conflicts of interest;
- act with impartiality in respect of all members and beneficiaries.⁷⁸

This demonstrates that fiduciary duties and trust-based governance structures can be replicated outside of the trust-based setting - although, as already indicated, it is important to go beyond such legal structures and consider how governments can ensure that fiduciary standards of care are met in practice.

⁷⁴ Law Commission, 1992, *op cit*, para 2.4.7 ⁷⁵ See UNEP-FI, 2005, *op cit*, pp75-76 ⁷⁶ German Investment Act 2004 ⁷⁷ Leg Decree No 58, 1998, Articles 21 & ff & 33 & ff ⁷⁸ Section 7C, The Pension Funds Act 1962

Workplace arrangements

In workplace contract-based pension arrangements, insurance companies do not have contractual relationships with trustees which could be said to give rise to ‘indirect’ fiduciary obligations. Instead, the insurance company has contractual relationships with each individual saver. Generally, there is no contractual relationship with the employer.

The employer is responsible for choosing the provider and selecting the fund options offered to members. Yet employers are not subject to any fiduciary duties to look after members’ interests when carrying out this function.⁷⁹ Moreover, the intermediaries who advise them on these decisions (usually Independent Financial Advisors or employee benefit consultants) are entirely unregulated save for their contractual relationship with the employer.⁸⁰

Some employers are voluntarily seeking to replicate the governance structures of a trust-based scheme: research by TPR found that around half had established ‘management committees’, although these were often informal with limited clarity over their role.⁸¹ Indeed, expanding the fiduciary duties of employers and encouraging the establishment of management committees have both been suggested as avenues for legal reform to tackle the ‘governance vacuum’ in contract-based schemes.⁸² However, there are limits to this approach. Auto-enrolment will bring 1.3 million employers under an obligation to enrol their employees into a pension scheme,⁸³ many of them small employers who may lack the skills or

“ Given the complexity of investment matters and the long horizon of pension matters, expectations [that market forces will lead to efficient outcomes] may seem unwarranted ”

capacity to take on this paternalistic role and would be likely to resist additional obligations. Focussing on the role of the employer may not remove the need to examine the governance and duties of the pension providers themselves.

Individual personal pensions

In the second category of contract-based pension arrangements, there is no employer at all. An individual pension saver who buys a pension product direct from Aviva or Standard Life is in a very different position from a member of a workplace pension scheme. On the one hand, it could be argued that since these individuals exercise consumer choice over their provider and product, they are less reliant on their agents than members of workplace arrangements and therefore less deserving of strong protections. On the other hand, the absence of any structures through which their interests are represented and defended in decision-making has the potential to make them more vulnerable, particularly given the information imbalances between consumers of complex

⁷⁹ Stewart, F. and J. Yermo, 2008, *op cit.* ⁸⁰ TPR, 2007, ‘Governance of work-based pension schemes’, para 12.18

⁸¹ TPR, Jan 2008, ‘DC Research: Data on the occupational DC landscape plus results of independent research’. p27

⁸² See for example Stewart, F. and J. Yermo, 2008, *op cit.*, pp29-30 ⁸³ Johnson, P., D. Yeandle & A. Boulding, Oct 2010, ‘Making automatic enrolment work: A review for the Department for Work and Pensions’ (DWP), para 6.2.1

financial products and their providers. As an OECD paper has observed, “*Given the complexity of investment matters and the long horizon of pension matters, expectations [that market forces will lead to efficient outcomes] may seem unwarranted.*”⁸⁴

Extending stronger duties to retail pension providers has been suggested as the equivalent of enhanced duties for employers in workplace arrangements.⁸⁵ Certainly, there would be value in greater legal certainty about the nature of these providers’ duties. Other options include strengthening the role of regulators and establishing more independent governance structures. This does not necessarily mean replicating trust-based structures. One interesting precedent in FSA rules is the requirement for a firm, when undertaking the reattribution of its inherited estate, to appoint a ‘policyholder advocate’ to negotiate with the firm on behalf of relevant policyholders. The advocate must be free from conflicts of interest which might prejudice the interests of policyholders, and the appointment process should include an ‘independent element’, such as consultation with representative groups of policyholders.⁸⁶ This model might have potentially broader application to more routine decisions, for instance through the establishment of standing ‘policyholder committees’.

Conflicts of interest

Despite their crucial role in today’s pensions landscape, there has been little public discussion about conflicts of interest in the particular case of insurance companies acting as retail pension providers. These providers are as prone to conflicts as any other: for example, conflicts may arise at an institutional level

between policyholders and shareholders, or at an individual level through activities such as personal share-dealing. According to a recent OECD paper,

*“Conflicting interests are at the heart of many of the complaints often heard about defined contribution plans, from high fees to unsuitable investments and poor performance. While improving members’ financial education and enhancing disclosure can help overcome some of the more blatant cases of abuse, it is highly unlikely to eliminate the massive information gap between private pension providers and individual plan members.”*⁸⁷

Some conflicts, such as self-dealing or cross-selling of different products to plan members, can be dealt with by regulations. For instance, pension providers in countries such as Portugal and Poland are subject to restrictions on investments in entities relating to the pension provider.⁸⁸ Others may be dealt with by the implementation of appropriate codes of conduct regarding conflicts of interest. In the UK, the Stewardship Code might be a starting point for such an approach. The Stewardship Code expressly states that the ‘institutional shareholders’ to which it is relevant include “*pension funds, insurance companies, investment trusts and other collective*

“ Given their increasing dominance when it comes to looking after people’s savings, active efforts should be made to bring insurance companies into the stewardship debate ”

⁸⁴ Stewart, F. and J. Yermo, 2008, *op cit*. ⁸⁵ Stewart, F. and J. Yermo, 2008, *op cit* ⁸⁶ FSA COBS 20.2.42R - 20.2.52G
⁸⁷ Stewart, F. and J. Yermo, 2008, *op cit* ⁸⁸ Stewart, F. and J. Yermo, 2008, *op cit*

*investment vehicles.*⁸⁹ Yet so far insurance companies have remained marginal to discussions about the Code, which have focussed largely on asset managers and occupational pension funds. At time of writing, 24 asset owners had signed up to the Code, almost all of them pension funds: the only contract-based providers to have done so were Equitable Life and the Pension Insurance Corporation.⁹⁰

Given their increasing dominance when it comes to looking after people's savings, active efforts should be made to bring these providers into the stewardship debate. Further work is also needed both on the prevention and management of conflicts of interest and on contract-based pension governance more generally.

Recommendation: *As part of a wider review of fiduciary obligation, the government should review the legal obligations that apply to contract-based pension providers, with the aim of ensuring that standards of care and accountability mechanisms are consistent across the market.*

Regulatory issues

The split between the legal duties of trust- and contract-based pension providers is more or less matched by a split in regulatory supervision. Trust-based occupational pension schemes are overseen by The Pensions Regulator, which focuses on ensuring good governance and protecting members' benefits. TPR also has some responsibility for work-place

personal pensions, shared with the FSA. Individual personal pensions, and the insurance companies which provide them, are regulated solely by the FSA.

Historically, the FSA's enforcement has tended to emphasis 'point of sale', ie. preventing mis-selling and ensuring that firms recommend suitable products to their clients, rather than on continuing investment governance. From 2004/05 the FSA attempted to move beyond this approach with its 'Treating Customers Fairly' initiative,⁹¹ but more recently it has acknowledged that this approach remained too reactive and largely failed to deliver improved outcomes for consumers.⁹² Its new consumer strategy focuses on proactive *early* intervention,⁹³ an approach that looks likely to continue under the new Financial Conduct Authority.⁹⁴ Yet it remains unclear whether this focus on early intervention will be matched by an enhanced focus on *continuing* intervention regarding investment governance and conflicts of interest. These issues do not generally appear to be seen as part of the consumer protection agenda, despite their significant implications for savers. For instance, it is disappointing that the recently-published FSA rule requiring disclosure of a firm's commitment to the Stewardship Code did not extend to firms acting for individual retail clients, on the basis that these customers had "*limited potential... to direct the stewardship practices of asset managers.*"⁹⁵ There is thus a danger that individual retail clients may have neither a fiduciary champion within the governance structure of their pension provider, nor a regulatory champion outside that structure.

⁸⁹ www.frc.org.uk/corporate/investorgovernance.cfm, accessed 15/03/11 ⁹⁰ www.frc.org.uk/corporate/stewardshipstatements.cfm#Asset_owners, accessed 15/03/11. The FRC has confirmed that signatories such as HSBC, The Co-operative and Aviva relate only to these firms' asset management arms, and not their capacities as retail pension providers. ⁹¹ See for example FSA, July 2006, '*Treating Customers Fairly: Towards Fair Outcomes for Consumers*' ⁹² Speech by Hector Sants, 12 March 2010, available online at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2010/0312_hs.shtml ⁹³ See FSA, March 2010, '*FSA CEO outlines new conduct regulation strategy*'; see also FSA, Jan 2011, '*Discussion Paper DP 11/1: Product Intervention*' ⁹⁴ See HM Treasury, Feb 2011, '*A new approach to financial regulation: Building a stronger system*' ⁹⁵ FSA, Handbook Notice 104, November 2010, p20

The current review of financial regulation offers an opportunity to ensure that consumer protection is consistent across the pensions market, that there is a level playing field between different types of pension provision and that the interests of individual pension savers in good investment governance do not fall between the cracks of different regulators' priorities. The government's recent consultation paper was encouraging in this respect, commenting:

*"It is important to remember that, in many wholesale markets, retail consumers have as much of an interest in the quality of wholesale conduct regulation as institutional investors or corporate clients, given that this is where their savings and pensions are ultimately invested. Dealing with these interactions and linkages will be part of the FCA's role as an integrated conduct regulator."*⁹⁶

Recommendation: *The Treasury should take the opportunity presented by the current review of financial regulation to ensure that the regulatory structure is streamlined and delivers equal levels of protection to all pension savers regardless of the form of their pension arrangements.*

Conclusion

If fiduciary obligation exists to govern those who are entrusted with another's interests, then asset managers, investment consultants and insurance companies are the fiduciaries of the future. Increasingly, these are the actors taking the investment decisions which will determine people's well-being in retirement. There is an urgent need for government to take stock of the existing framework, which has evolved in

a more or less ad hoc way, and to consider how to ensure that all pension savers, whoever their assets are entrusted to, receive robust and comparable protection.

This need not mean replicating the structures of traditional trust-based provision. Neither will it be enough simply to designate a certain set of actors as 'fiduciaries'. Rather, it must mean examining the underlying concepts of fiduciary obligation, considering what value they add to existing contractual and professional obligations, and exploring how those valuable elements can be applied coherently and consistently across all pension provision.

Nor should this process adhere slavishly to existing interpretations of trustees' own fiduciary obligations. It is vital that any review of where fiduciary duties lie goes hand in hand with a critical re-examination of where existing interpretations are proving dysfunctional or inadequate, and avoids simply transferring these problems to a new set of actors. In the remaining chapters, we suggest some particular areas that deserve consideration.

The particular value added by a proper understanding of fiduciary obligations lies in the duty of loyalty. This could provide a starting point not just for a renewed appreciation of the duties of commercial investment agents, but for the consideration of practical measures to ensure that conflicts of interest are monitored, managed and, wherever possible, avoided altogether. In particular, the duty of loyalty speaks to the ongoing debate over what has been characterised as 'agency capitalism', putting the individuals whose money is at stake back at the heart of debates about corporate governance and financial regulation. This chapter is intended as a catalyst for and contribution to this crucial debate.

⁹⁶ HM Treasury, Feb 2011, 'A new approach to financial regulation: Building a stronger system', para 4.68.

Chapter Summary

Asset managers	<p>It is our belief that the relationship between asset manager and client is a fiduciary one. However, opinion is divided on this question, and it is equally uncertain whether fiduciary obligations are understood and applied in practice. It might be helpful for the FSA (in consultation with TPR) to clarify the circumstances under which asset managers are fiduciaries and to offer some guidance on what this entails, particularly as regards the management of conflicts of interest.</p>
Investment consultants	<p>In the US, the relationship between investment consultants and their clients is regarded as a fiduciary one - but this acceptance does not appear to extend to the UK. Again, there might be merit in clarification of the position from the FSA - but the US experience also confirms the need to look beyond the fiduciary label, asking whether it has delivered higher levels of protection for beneficiaries in practice, and if not, what further measures could be taken to ensure that these are achieved.</p>
Insurance companies	<p>The position of insurance companies is much less clear-cut, and may differ for different parts of their business (for instance, insured trust-based schemes, work-place group personal pensions and individual personal pensions). Individual retail clients would seem to be particularly vulnerable in this respect. If it is concluded that the relationship between insurance companies and policyholders is not a fiduciary one, it becomes all the more important that their interests are robustly defended, both internally (through the governance structures in place) and externally (by a strong regulator).</p>

Summary of Recommendations

- The *FSA/FCA* should remind asset managers of their fiduciary status and of the fact that this may entail stricter obligations than those imposed by regulatory rules. It should also seek to improve firms' understanding and application of fiduciary obligations, with a particular focus on the prevention, management and disclosure of conflicts of interest.
- The *FSA/FCA* should confirm that investment consultants are fiduciaries in relation to their clients and should work to ensure that these obligations are understood and applied in practice, with a particular focus on the prevention, management and disclosure of conflicts of interest.
- As part of a wider review of fiduciary obligation, the **government** should review the legal obligations that apply to contract-based pension providers, with the aim of ensuring that standards of care and accountability mechanisms are consistent across the market.
- The *Treasury* should take the opportunity presented by the current review of financial regulation to ensure that the regulatory structure is streamlined and delivers equal levels of protection to all pension savers regardless of the form of their pension arrangements.
- **Trustees** should seek to avoid and manage conflicts of interest not just within the trustee board itself, but also their service providers. In particular, funds should request information regarding the policies their asset managers and consultants have in place to ensure that specific relevant conflicts are properly managed.
- **TPR** should take steps to ensure that the training available to trustees on the critical matter of monitoring asset managers is sufficiently robust and independent. There is also a role for **trade unions** in providing continued support for member-nominated trustees.
- **Small pension schemes** should be encouraged and enabled to consolidate, bearing in mind the per member unit costs of running small schemes and the generally higher quality of scheme governance and member communications in larger schemes.



Chapter

Incentivising Responsibility

Overcoming barriers to
responsible investment

“ *It is not a breach of fiduciary duties per se to have regard to ESG considerations while pursuing the purposes of the trust. Rather, in our opinion, it may be a breach of fiduciary duties to fail to take account of ESG considerations that are relevant and to give them appropriate weight* ”

The Freshfields Report, 2005

In 2005, the United Nations Environment Programme's Finance Initiative (UNEP-FI) commissioned a report from law firm Freshfields Bruckhaus Derringer on the extent to which investors' fiduciary duties allow for the consideration of non-financial issues.¹ This seminal report - now widely known as the 'Freshfields opinion' - confirmed that where environmental, social and governance (ESG) issues are financially material, investors are not only permitted but arguably *required* to take them into account (see Box B). The authors of the report have since described this opinion as "*intentionally conservative*."² Indeed, it is essentially a restatement of the orthodox view of fiduciary obligation using ESG language. Clearly, if investors have a duty to act prudently and to seek the best financial return, they must take all material issues into account regardless of how they are labelled. Even staunch critics of 'ethical investment' (such as Rosy Thornton) acknowledge the validity of the Freshfields opinion, since under its terms "*decisions are not being made on ethical grounds at all but merely on financial ones, in line with current legal principle*."³ The more contentious question of whether fiduciary investors can take non-financial issues into account for their own sake (also considered by the Freshfields report) is dealt with in the next chapter.

The model which derives from the Freshfields view - now known as 'Responsible Investment' - has been embraced by some of the biggest and best-resourced UK pension funds, led by pioneers such as the Universities Superannuation Scheme, Railpen, the BT Pension Fund and the Environment Agency

Pension Fund. Moreover, the UN Principles for Responsible Investment now has 877 global signatories⁴ worth a combined \$22 trillion in assets under management,⁵ including 111 in the UK.⁶

The challenge now is to translate this widespread acceptance of Responsible Investment in *principle* into a shift in standard investment *practice*. FairPensions' research suggests that such a sea-change has yet to take place. In our 2009 survey, most large UK pension funds made some reference to ESG issues in their Statements of Investment Principles, but around a third did not integrate this into their investment mandates or into their monitoring and review of fund managers.⁷ One participant in our second seminar, from a pension fund noted as a prominent responsible investor, said that "*even now we're often told [by asset managers] that we're in the minority of clients who ask about this*." Many investors still appear to regard ESG integration as an optional 'add-on', or the preserve of specialist 'socially responsible' investors, rather than as an integral part of the fulfilment of their fiduciary duties. What, then, is holding Responsible Investment back, and how can these barriers be overcome? This chapter considers various possible barriers, including lack of evidence, lack of awareness and lack of incentives. It concludes that the most significant barriers are the continuing confusion over the relationship between fiduciary duties and ESG integration, and the mismatch between short-term incentive structures and the long-term nature of ESG risks.

¹ UNEP FI, 2005, 'A legal framework for the integration of environmental, social and governance issues into institutional investment' ² UNEP FI, 2009, 'Fiduciary responsibility: Legal and practical aspects of integrating environmental, social and governance issues into institutional investment', p24 ³ Rosy Thornton, 'Ethical Investments: A Case of Disjointed Thinking', Cambridge Law Journal, 67(2), July 2008, p412 ⁴ <http://www.unpri.org/signatories/> (accessed 7/02/11) ⁵ Responsible Investor, Jan 18 2011, 'UNPRI plans annual ESG progress disclosure by signatories'. ⁶ <http://www.unpri.org/signatories/index.php?country=UK> (accessed 7/02/11) ⁷ See FairPensions, 2009, 'UK Occupational Pension Schemes' Responsible Investment Performance 2009.'

Box A: Responsible Investment

The UN Principles for Responsible Investment (UNPRI) defines Responsible Investment as “*the integration of ESG criteria into mainstream investment decision-making and ownership practices*”.⁸ Responsible Investment (sometimes more narrowly known as ‘business-case RI’)⁹ generally advocates the consideration of ESG factors as financially material issues, rather than for the social or moral reasons emphasised by more traditional ‘ethical investment’. The preamble to the UNPRI states:

*“As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios”.*¹⁰

Responsible Investment often emphasises the exercise of shareholder rights, including voting and dialogue with companies, rather than the application of positive or negative ‘screens’.

Box B: The Freshfields Report

UNEP-FI asked the law firm Freshfields Bruckhaus Derringer “*whether the law restricts us, as asset managers, from seeking to attend to broadly accepted extra-financial interests of savers in conjunction with their financial interests.*” Freshfields analysed the legal duties of investment decision-makers in various jurisdictions, including the fiduciary duties applicable under US and UK law. It also reviewed the evidence on the financial materiality of ESG issues.

The report’s landmark conclusion is that “*integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions.*”¹¹ It considers that “*the links between ESG factors and financial performance... are widely acknowledged to exist*”, and that understanding ESG issues “*may help the decision-maker understand the nature, externalities, risk and likely return of the investments undertaken*”, as well as “*the likely longer-term viability and/or sustainability of certain investments.*”¹²

⁸ Available at www.unpri.org ⁹ See Benjamin Richardson, 2008, ‘*Socially Responsible Investment Law*’ (Oxford University Press), p14 ¹⁰ Available at <http://www.unpri.org/principles/> (accessed 10/03/11) ¹¹ UNEP-FI, 2005, *op cit*, p13 ¹² UNEP-FI, 2005, *op cit*, p95

Box B: The Freshfields Report (continued)

The concluding section summarises the legal position as follows:

“The question is not a zero-sum equation of either maximising returns or favouring ESG issues, but of taking all relevant factors into consideration in a prudent and properly motivated investment analysis. It is not a breach of fiduciary duties per se to have regard to ESG considerations while pursuing the purposes of the trust. Rather, in our opinion, it may be a breach of fiduciary duties to fail to take account of ESG considerations that are relevant and to give them appropriate weight.”¹³

Lack of evidence?

It is hard to dispute the principle that financially material ESG issues should be taken into account just like any others. The first question, then, is whether there is widespread agreement on the extent to which ESG issues *are* material. There are two inter-related issues here. Firstly, in the absence of clear, quantifiable evidence, investors may still have doubts as to whether devoting resources to ESG integration is either legally justified or financially worthwhile. Secondly, even if investors do believe ESG issues have financial impacts, the difficulty of quantifying these impacts could present

a practical barrier to their integration into investment analysis. Indeed, the intangible nature of ESG impacts is often put forward as one reason for the slow uptake of Responsible Investment practices.

On the first of these questions, whilst more data is always useful, there is a growing body of evidence on the financial impact of ESG issues which should be sufficient to justify Responsible Investment as a prudent strategy.

Anecdotal evidence

Experience demonstrates that inattention to issues like health and safety or environmental impacts can be financially damaging. The financial crisis has prompted a heightened awareness of the risks associated with poor corporate governance, such that few would now dispute the value of shareholder engagement over governance issues such as executive remuneration or board composition. Whether the Gulf of Mexico oil spill - which forced BP to cancel its dividend for the first time since the Second World War¹⁴ and to report its first annual loss in nineteen years¹⁵ - will have a similar catalytic effect for environmental and social issues, remains to be seen. Before the disaster, BP already had an extremely poor health and safety record: in 2009 it was the subject of a record fine from the Occupational Safety and Health Authority (OSHA) after failing to correct the problems that led to the 2005 Texas City refinery explosion.¹⁶ As we now know, investors ignored these warning signs at their peril - the costs to the company in claims and other payments have so far reached over \$5bn.¹⁷

¹³ UNEP-FI, 2005, *op cit*, p100 ¹⁴ BBC, 17 June 2010, ‘BP to fund \$20bn Gulf of Mexico oil spill payout.’ <http://www.bbc.co.uk/news/10335114> (accessed 10/03/11) ¹⁵ BP, 1 Feb 2011. <http://www.bp.com/genericarticle.do?categoryId=2012968&contentId=7066971> (accessed 10/03/11) ¹⁶ OSHA, 30 Oct 2009, ‘News Release: US Dept of Labor’s OSHA issues record-breaking fine to BP’; OSHA BP History Fact Sheet, <http://www.osha.gov/dep/bp/bphistory.html>, accessed 11/03/11 ¹⁷ BP website, www.bp.com/sectiongenericarticle.do?categoryId=9034722&contentId=7064398, (accessed 02-03-11)

Theoretical evidence

At the theoretical level, there is also increasing recognition of the validity of ‘universal owner’ arguments. For long-term investors with holdings across all economic sectors, returns will depend not just on the performance of individual companies but on the performance of the economy as a whole.¹⁸ Such owners therefore have an interest in avoiding the creation of negative social or environmental externalities by companies in their portfolio - even if the company in question derives enormous profits from this business strategy - for which the costs will be borne elsewhere in the economy to the detriment of their portfolio as a whole. An obvious example is climate change: as a 2009 UNPRI report noted, pension providers’ position as long-term universal owners

“makes it difficult for them to avoid systemic risks of the kind that unmitigated climate change will impose on them. As a result, prudent pension funds have good reason to pursue cost-effective strategies to support climate change mitigation and adaptation. Arguably, this may even be part of their fiduciary duty.”¹⁹

Empirical evidence

There is also a significant body of research which suggests that taking ESG issues into account can improve financial performance. One recent study used quantitative modelling of ESG risk factors in a portfolio to determine that, over a 20-year horizon, integrating ESG into equity allocation gave a risk reduction of around 30% at the same level of expected return,

or an increase in expected return of 30 basis points at the same level of risk.²⁰ Another compared the actual historical performance of the eight largest US mutual funds with the eight largest ‘responsible’ funds, and found that the funds which incorporated ESG delivered higher risk-adjusted returns over one- and three-year periods.²¹ A 2007 meta-analysis by Mercer found evidence of a positive correlation between ESG integration and performance that was strongest for approaches that emphasised shareholder engagement (as opposed to excluding companies or sectors).²² A 2011 analysis by Mercer found that climate policy could contribute as much as 10% to overall portfolio risk, with the economic cost expected to amount to \$8 trillion by 2030.²³ And a 2006 UNEP report, using a range of methods, including benchmarking, scenario analysis and case studies, concluded that *“there is robust evidence that ESG issues affect shareholder value in both the short and the long term”* and that *“the impact of ESG issues on share price can be valued and quantified.”²⁴*

We do not pretend this evidence is unequivocal, but the case is certainly strong. Conclusive proof of the future materiality of ESG is an impossible demand, since past experience is never a guide to future performance. Yet the assumption that conclusive proof is needed before trustees are free to act goes to the heart of a common misconception: that trustees’ fiduciary obligations constitute a duty to be right all the time, or to accurately predict future performance. Such a standard would be impossible to

¹⁸ Hawley & Williams, 2000, ‘The rise of fiduciary capitalism: How institutional investors can make corporate America more democratic’ (University of Pennsylvania Press), p xv ¹⁹ UNPRI, 2009, ‘Investor leadership on climate change: An analysis of the investment community’s role on climate change, and a snapshot of recent investor activity’ ²⁰ Allianz Global Investors, 2010, ‘ESG Risk Factors in a Portfolio Context’. ²¹ Trucost & RLP Capital, 2010, ‘Carbon Footprints, Performance and Risk of US Equity Mutual Funds’ ²² Asset Management Working Group of the UNEP Finance Initiative and Mercer, 2007, ‘Demystifying Responsible Investment Performance: A review of key academic and broker research on ESG factors’ ²³ Mercer, 2011, ‘Climate Change Scenarios: Implications for Strategic Asset Allocation’ ²⁴ UNEP Finance Initiative Asset Management Working Group, 2006, ‘Show Me The Money: Linking Environmental, Social and Governance Issues into Institutional Investment’, p11

meet, not just for ESG integration but for any aspect of investment decision-making. Instead, as the Freshfields Report emphasised, the test applied by courts is about *process* rather than *outcome*:²⁵ did trustees follow an appropriate process? Did they take reasonable and prudent decisions, taking into account all relevant considerations and in line with the purpose of the trust?²⁶ Particularly given the lack of evidence that prudent consideration of ESG issues *harms* performance, the available evidence appears more than sufficient to meet this reasonableness test.

Clearly, further research would strengthen the case that ESG integration deserves to be given weight and allocated resources in the context of many competing priorities. In particular, it may be difficult to make sweeping generalisations from studies which use varying metrics and consider various different approaches to ESG integration. Nonetheless, it appears that the slow penetration of Responsible Investment into the mainstream is not primarily due to a lack of evidence that ESG issues are material. The idea that the case for ESG integration has yet to be conclusively established, or that investors might be justified in neglecting ESG issues altogether in the absence of new evidence, risks becoming a distraction from other barriers to greater uptake of Responsible Investment.

Integrating ESG into investment analysis

Even if the general evidence linking ESG issues to financial performance is robust, this still leaves the practical problem of how investors are to quantify the impact

“ The idea that the case for ESG integration has yet to be conclusively established, or that investors might be justified in neglecting ESG issues altogether in the absence of new evidence, risks becoming a distraction ”

of a particular ESG issue in such a way as to incorporate it into their analysis of a company or sector. There is still a widespread perception that non-financial issues are insufficiently ‘objective’ to be integrated in this way. This view has been challenged by various commentators, including by the Freshfields Report itself, which noted:

“It is increasingly difficult for investment decision-makers to claim that ESG considerations are too difficult to quantify when they readily quantify business goodwill and other equivalently nebulous intangibles.”²⁷

Nonetheless, it must be acknowledged that some ESG issues are easier to quantify than others. For instance, environmental assessment is now fairly well established and understood, and indicators such as carbon footprint are increasingly susceptible to measurement and valuation.

²⁵ See UNEP FI, 2005, *op cit*, p10 ²⁶ See for example *Cowan v Scargill* [1984] All ER 750; [1985] Ch270, *Martin v City of Edinburgh District Council* [1988] SLT 329, [1988] SCLR 90 ²⁷ UNEP-FI, 2005, *op cit*, p11

The consensus on what constitutes the ‘S’ in ESG, and how it is to be measured, is much more hazy. Initiatives like the Equator Principles require their signatories to conduct social assessments of projects under certain circumstances, but expertise in such social assessment is less well developed.²⁸ Indices such as FTSE4Good do include criteria on social factors, such as supply chain issues or combating bribery,²⁹ and new methodologies, such as ‘Social Return on Investment’, are helping to advance thinking on measuring social impacts in a reliable and comparable way.³⁰ But there is clearly some way to go in this area.

Poor reporting by companies may also be a barrier to quantification of ESG issues by investors. This applies both to quantitative reporting - for instance, data on greenhouse gas emissions which would allow investors to quantify carbon liabilities - and to narrative reporting about the principal risks and uncertainties facing a company. Many investors complain that CSR reports provide little insight into material issues affecting the core business, with a tendency to focus on charitable activities and side-projects aimed at demonstrating good ‘corporate citizenship’. In responses to the government’s 2010 consultation on narrative reporting, *“reporting of social and environmental matters in particular was viewed by some as poorly integrated into the strategy and risks of the business and as a result did not provide relevant and consistent information.”*³¹

“ Many investors complain that CSR reports provide little insight into material issues affecting the core business, with a tendency to focus on charitable activities and side-projects aimed at demonstrating good ‘corporate citizenship’ ”

The work of the International Integrated Reporting Committee reflects this sense that investors will only be able to integrate ESG issues fully into their analysis if companies integrate them fully into their reporting.³² Integrated reporting could also help to overcome the cultural barrier identified by many seminar participants whereby ESG tends to be viewed as an optional extra rather than an integral part of investment analysis. Arguably, investors should do more to challenge inadequate corporate reporting - and civil society also has a role to play, as illustrated by environmental law organisation Client Earth’s recent complaint to the regulator, which resulted in enhanced information being included in Rio Tinto’s 2010 Annual Report.³³ But such action cannot be a substitute for clear and properly enforced regulatory requirements.

²⁸ See Paul Watchman, ‘The Equator Principles: Raising the Bar on Social Impact Assessments’, in Amnesty International, 2006, *‘Human rights, trade and investment matters’*, pp15-17 ²⁹ See for example FTSE4Good Supply Chain Criteria, available online at http://www.ftse.com/Indices/FTSE4Good_Index_Series/F4G_Download_Page.jsp (accessed 10/03/11) ³⁰ See The Social Return on Investment Network, 2009, *‘The Guide to SROI’*, available online at www.thesroinetwork.org ³¹ BIS, 2010, *‘Summary of Responses: The Future of Narrative Reporting - A Consultation’*, p6 ³² See www.integratedreporting.org ³³ Client Earth, 2010, *‘Referral to the FRRP re. the Rio Tinto Group Annual Report 2008’*, available online at www.clientearth.org; FRRP, 15 March 2011, *‘Statement of the FRRP in respect of the report and accounts of Rio Tinto plc’*, available at <http://www.frc.org.uk/frfp/press/pub2539.html>

Recommendation: *Companies should integrate environmental and social information into their reporting, including narrative reports. As part of its review of narrative reporting, BIS and the FRC should seek to promote the concept of integrated reporting and should explicitly clarify the need to ensure that environmental and social reporting is forward-looking and strategic rather than being siloed into backward-looking CSR or sustainability reports.*

Lack of awareness

The level of awareness among pension fund trustees, both of the Freshfields opinion and of the ways in which ESG issues may be material, continues to be low. In a 2009 study for the Association of Chartered Certified Accountants (ACCA) on trustees' attitudes to climate change, most had limited understanding of the materiality of climate risk, and there was substantial confusion over whether consideration of climate change formed part of their fiduciary duty.³⁴

There is no shortage of publications aimed at improving trustees' understanding of ESG issues and providing them with tools for ESG integration: the Carbon Trust,³⁵ Mercer,³⁶ UKSIF,³⁷ the TUC³⁸ and the Local Authority Pension Fund Forum (LAPFF)³⁹ are among the organisations that have produced such guides. Yet studies show

that most trustees remain unaware of these publications.⁴⁰ What is lacking is *authoritative* guidance backed by the regulator. As well as contributing to poor understanding, this exacerbates legal uncertainty created by the lack of relevant legislation and case law. Interpretations of the legal position on extra-financial issues rely heavily on a small number of cases (the classic example being *Cowan v Scargill* – see Box A in Chapter 4) whose circumstances bear “*little or no resemblance*” to modern Responsible Investment practices.⁴¹ This appears to heighten trustees' fear that they are uniquely exposed to risk because of their fiduciary duties, contributing to a perception on ESG that “*it is safest not to test these waters*” (Claire Woods, Oxford University).⁴²

The difficulty that voluntary initiatives have had in breaking through these preconceptions suggests a strong case for government action to clarify the law. In a 2008 study of ten top European pension funds by Axel Hesse, most participants felt that statutory clarification to provide legal certainty on the extent to which sustainability should be taken into account by fiduciaries would be desirable.⁴³ ACCA's 2009 study also highlighted an “*urgent need*” for a government-backed code of practice for trustees on extra-financial issues.⁴⁴ The Financial Reporting Council's Stewardship Code,⁴⁵ although a welcome development, does not meet this need, since it focuses on the general process of shareholder engagement rather than the

³⁴ Solomon, 2009, ‘*Pension Fund Trustees and Climate Change*’ (ACCA) ³⁵ Carbon Trust, 2005, ‘*A Climate for Change: A Trustee's Guide to Understanding and Addressing Climate Risk*’ ³⁶ Ibid ³⁷ Higgs, C. & H. Wildsmith, 2005, ‘*Responsible Investment Trustee Toolkit*’ (Just Pensions). See also http://www.uksif.org/projects/sustainable_pensions/library ³⁸ TUC, 2009, ‘*Engaged Investment: A TUC Trustees' Guide*’ ³⁹ LAPFF, 2011, ‘*Investing in a Changing Climate*’ ⁴⁰ Solomon, 2009, ‘*Pension Fund Trustees and Climate Change*’ (ACCA) p27 ⁴¹ See UNEP-FI 2005, *op cit*, p89 ⁴² Woods, C. (forthcoming, 2011) ‘Funding climate change: how pension fund fiduciary duty masks trustee inertia and short-termism’, in Hawley, J., Kamath, S. and A.T. Williams (eds.) ‘*Corporate Governance Failures: The Role of Institutional Investors in the Global Financial Crisis*.’ (University of Pennsylvania Press). ⁴³ Hesse, 2008, ‘*Long-term and sustainable pension investments: A study of leading European pension funds*’, p44 ⁴⁴ Solomon, 2009, ‘*Pension Fund Trustees and Climate Change*’ (ACCA), p37 ⁴⁵ FRC, 2010, ‘*The UK Stewardship Code*’, available online at www.frc.org.uk. The Stewardship Code's Principle 4 acknowledges that environmental and social issues may be among those on which investors wish to engage, but it does not give these issues specific profile in the way that, for example, the South African Code does (see Box C).

substantive question of ESG integration. In addition, there may be a need for better trustee training - whether this is provided by regulators, the Pensions Management Institute, trade unions, civil society or the investment community - if real progress is to be made in raising trustees' awareness of Responsible Investment.

“*In a 2008 study of ten top European pension funds by Axel Hesse, most participants felt that statutory clarification to provide legal certainty on the extent to which sustainability should be taken into account by fiduciaries would be desirable*”

Whose duty?

There appears to be a strong tendency among actors at all stages of the investment chain to see ESG integration as 'somebody else's problem'. Commercial agents such as asset managers and consultants often factor in ESG only if their clients demand it, while the clients - pension fund trustees - assume that it is their agents' job to decide what considerations are material.

For instance, when FairPensions surveyed asset managers in 2009 about their attitudes to climate change, 89% rated it as an 'important' or 'very important' investment issue - yet only 29% integrated climate data into their analyses for all companies where it was available.⁴⁶

One of the biggest reasons given for this discrepancy was lack of client demand: in other words, asset managers placed the blame at the door of pension funds for failing to instruct them to factor in sustainability.

“*There appears to be a strong tendency among actors at all stages of the investment chain to see ESG integration as 'somebody else's problem'*”

Yet many trustees mirror this attitude by treating it as the fund manager's responsibility to consider such factors where relevant, just as they would any other material consideration. ACCA's 2009 study concluded that “[trustees’] decision to delegate investment decisions to their fund managers has led to an impression that this frees them from a need to consider potentially material risk factors such as climate change.”⁴⁷ As one trustee put it, “We’re expecting our managers to have that skill... It’s not our place as trustees to dictate to a manager...”

⁴⁶ FairPensions, 2009, ‘Preparing for the Storm? UK investment managers and the risks and opportunities of climate change’ ⁴⁷ Solomon, 2009, ‘Pension Fund Trustees and Climate Change’ (ACCA), p24

If these companies are at risk of not being sustainable as businesses, that's for them to factor into their fundamental analysis."⁴⁸ Legally speaking, of course, the appointment of fund managers does not free trustees from the obligation to exercise their own judgement on relevant considerations (see Chapter 2 for a more detailed discussion).

Finally, a similar attitude can be found among many investment consultants. In a survey of consultants conducted for UNEP-FI's 2009 follow-up to the Freshfields report, only half thought they had a responsibility to proactively raise ESG issues with clients, with the rest viewing their role as "secondary or reactive".⁴⁹ A 2009 Eurosif survey was slightly more encouraging, with 63% of consultants saying that they proactively raised Responsible Investment in meetings with clients - but the report noted that "this was not quite consistent with other results of the survey showing that client demand remains the main driver for consultants to offer responsible investment services."⁵⁰

The role of consultants is crucial since, as one participant in our seminar observed, "The vast majority of trustees... are completely dependent on investment advisers... with the best will in the world, the extra training that regulators will provide is never going to get them to a place where they can turn around to their investment consultants and say, 'You were wrong'." UNEP-FI's 2009 report argued that "investment consultants and asset

managers have a professional duty of care to proactively raise ESG considerations with their clients", regardless of whether the client requests it.⁵¹ Yet the above evidence suggests that we are a long way from consensus that such a positive duty exists.

It is easy to see how this widespread denial of responsibility might lead to ESG integration slipping through the cracks. Guidance from regulatory bodies as to the respective responsibilities of trustees and their agents might help overcome this impasse: for instance, such guidance could clarify that trustees should incorporate ESG into their investment mandates, and that consultants should raise ESG when advising on Statements of Investment Principles. But it should also be acknowledged that this apparent buck-passing may reflect a deeper problem: a lingering perception of ESG as a client-driven ethical preference, rather than a truly integral part of financial analysis.⁵²

Recommendation: *DWP should ensure that any new guidance for trustees provides confirmation that fiduciaries should consider ESG issues which may be financially material. This could be accompanied by more detailed guidance on the respective roles of trustees, asset managers and consultants.*

⁴⁸ Ibid ⁴⁹ UNEP-FI, 2009, *op cit*, p36 ⁵⁰ Eurosif, 2009, 'Investment Consultants and Responsible Investment Study', p13 ⁵¹ UNEP-FI, 2009, *op cit*, p28 ⁵² See for example Towler, J. 2011, 'The ESG principles vs returns dilemma', NAPF Investment Conference 2011: pp56-57

Myths and misconceptions: cultural and legal barriers

Residual hostility

This residual hostility to Responsible Investment is a common thread running through many of the barriers discussed so far. The demand for ever-more data on the financial impacts of ESG reflects the appreciably higher bar that tends to be set for ESG inclusion than for other considerations. As one seminar participant put it, *“The kind of hoops you need to jump through on ESG are completely different from any other investment decision.”*

Likewise, trustees’ level of awareness reflects the fact that the training and advice they receive, both from asset managers or consultants and from lawyers, tends to present a conservative view of the current legal position. For instance, anecdotal evidence suggests that trustees are far more likely to know about the judgement in *Cowan v Scargill*, and to believe that this prohibits them from considering any extra-financial issues, than they are to be aware of the Freshfields report.

Finally, the prospect of liability for breach of fiduciary obligation appears to be invoked disproportionately to justify ignoring ESG issues. It is interesting to contrast the reaction of pension funds to a shareholder resolution on oil sands at BP’s 2010 AGM with their reaction to the Gulf of Mexico oil spill some weeks later. The

resolution asked only that the company disclose more information to shareholders about the business risks associated with their oil sands projects - including in relation to outsourcing and emergency scenarios. Many pension funds nevertheless responded (in our view, wrongly) that it would be a breach of their fiduciary duty to vote for it. Yet when the same company suffered an enormous loss because of an environmental disaster on an out-sourced drilling platform, nobody was concerned that the resulting pension fund losses might leave them exposed to liability for failing to address these non-financial risks. This begs the question whether fiduciary duty is, in some cases, simply a convenient smokescreen for actors unwilling to attend to ESG considerations.

“ *The prospect of liability for breach of fiduciary obligation appears to be invoked disproportionately to justify ignoring ESG issues* ”

The world of pensions and investments has been characterised as “*a deeply conservative industry*”⁵³ - but this seems too simplistic. It cannot simply be a question of resistance to innovation: indeed, in the wake of the financial crisis the investment industry has more often been accused of too much innovation than too little. And, although pension funds are indeed often more cautious than other investors, some have been very willing to embrace non-traditional products and asset classes. For example, from 2000-2009 the proportion of pension fund assets in ‘alternative’ investments increased from 0.8% to 7.1%.⁵⁴ Yet there does appear to be a lingering reluctance to attend to ESG issues in many quarters, as well as a tendency to equate financially-motivated ESG integration with ethically-motivated screening, which continues to be viewed with suspicion by many investors.

The ‘duty to herd’

Part of the reason for these apparent paradoxes may lie in the well-rehearsed problem of herding behaviour. It was precisely because large swathes of the investment industry moved together into exotic derivatives that pension funds felt safe in following. Conversely, in the absence of strong momentum towards ESG integration, the status quo becomes self-perpetuating: progress is likely to remain slow unless everybody jumps together. Residual uncertainty about ESG may have made some funds feel they would be ‘sticking their neck out’ by voting for the 2010 resolutions on oil sands. When disaster struck they felt safe from criticism because, in failing to scrutinise BP’s

risk management, they had behaved no differently from the vast majority of other investors.

As we saw in Chapter 1, prevailing interpretations of fiduciary duty may unintentionally reinforce this tendency: the duty of prudence is interpreted as a duty to herd, making trustees feel bound to stick to prevailing investment norms if they are to avoid liability. This creates an inertia which passes up the chain - for instance, investment consultants feel that they themselves would be exposed if they gave advice which diverged from prevailing norms. Actors feel constrained from adopting prudent strategies which are not yet mainstream, and this in turn inhibits those strategies from becoming mainstream.

“ *The duty of prudence is interpreted as a duty to herd, making trustees feel bound to stick to prevailing investment norms if they are to avoid liability* ”

⁵³ From our second seminar: FairPensions, June 2010, ‘Prudence redefined’ ⁵⁴ (IMA Annual Survey 2009-10, p31

In fact, in the case of Responsible Investment the presumed legal danger of departing from industry norms is largely mythical: although courts do interpret the duty of prudence by reference to the behaviour of other investors, they do not assume that there is only one prudent strategy, determined by reference to whatever the majority of investors are doing, but rather a wide spectrum of prudent approaches.⁵⁵ The \$22 trillion worth of signatories to the UNPRI would

likely be more than sufficient to convince a court that a properly-motivated strategy of ESG integration satisfied the ‘ordinary prudent man’ standard. Nonetheless, there remains a mismatch between perception and reality. Explicit confirmation from the government that fiduciary investors should consider ESG issues (of the kind recently given in South Africa) would help to ensure that the law unambiguously supports rather than stifles progress in this area.

Box C: Case Study - South Africa

In 2010, a South African investor-led initiative announced its intention to produce a code to parallel the UK Stewardship Code, published earlier that year. The draft Code (released in September 2010) differs from the UK Code in placing a strong emphasis on environmental, social and governance issues. Indeed, it has been titled ‘Draft Code for Responsible Investing’. Of its four key Principles, the first two state:

1. “An institutional investor should incorporate ESG considerations into its investment analysis and activities as part of the delivery of superior risk-adjusted returns to the ultimate beneficiaries.”
2. “An institutional investor should demonstrate its ownership approach in its investment arrangements and activities... [including] standards to be applied for the identification of ESG concerns”.⁵⁶

More recently, the South African government has introduced into new regulations, due to come into force in July 2011, a number of high-level principles for the investment of fund assets which a fund and its board must apply at all times. These principles include the following: “*before making an investment into and while invested in an asset, consider any factor which may materially affect the sustainable long term performance of the investment, including those of an environmental, social and governance character.*”⁵⁷ The preamble to the regulations also emphasises that the fiduciary duty of funds to invest prudently will include proper consideration of ESG issues.⁵⁸

⁵⁵ See UNEP-FI, 2009, *op cit*, p28 ⁵⁶ South African Institute of Directors, Sept 2010, ‘Draft Code for Responsible Investing by Institutional Investors in South Africa’. Available online at http://www.iodsa.co.za/products_reports.asp?CatID=362 ⁵⁷ South Africa National Treasury, 23 February 2011, ‘Pension Funds Act, 1956: Amendment of Regulation 28 of the regulations made under Section 36’. Section 1(b)(viii) ⁵⁸ *Ibid*, Preamble (p3)

Recommendation: *The FRC should ensure that future revisions of the Stewardship Code place explicit emphasis on environmental and social issues as well as on governance.*

Perverse incentives

One thing that distinguishes ESG integration from the ‘innovative’ investment strategies and products which *have* taken hold and prospered is the absence of clear, strong incentives for key actors. Ultimately, it must be acknowledged that - regardless of the other practical and legal barriers identified - true integration of ESG into mainstream investment practice remains unlikely as long as nobody is incentivised to do it.

“ True integration of ESG into mainstream investment practice remains unlikely as long as nobody is incentivised to do it ”

Notwithstanding the considerable evidence that ESG issues are material, there is a mismatch between the benefits of ESG integration and the way fund managers are remunerated. The financial benefits of ESG integration are seen largely in terms of long-term risk management rather than as a means to achieving outsized

returns in the shorter term. It has been suggested that this may be a presentational problem: responsible investors need to stop focussing exclusively on ‘risks’ and start talking about ESG ‘opportunities’. Even so, it remains true that there are no obvious short-term profits to be realised from better scrutiny of investee companies’ carbon liabilities. Although the long-term benefits of improved risk management should be sufficient to make ESG integration a prudent part of serving beneficiaries’ interests, they may not be sufficient to incentivise asset managers actively to embrace the extra effort involved.

Indeed, prevailing remuneration structures based on short-term, benchmark-relative performance may actively disincentivise ESG integration. If, by addressing long-term ESG risks, fund managers run the risk of short-term under-performance relative to the benchmark, they may miss targets, forfeit bonuses, and ultimately even lose mandates. As discussed above, evidence suggests that ESG integration does not in practice carry any performance penalty even in the short-term - but given the lingering perception that it might, this will still act as a disincentive. As Paul Watchman puts it, current incentive structures mean fund managers are “*bound to be looking at quick hits*” rather than long-term sustainable value creation - even if this does not serve the best interests of beneficiaries.⁵⁹ Once again, this tendency is arguably reinforced by prevailing interpretations of the fiduciary duty of prudence which privilege the maximisation of short-term return over the management of systemic risks to beneficiaries’ capital (see Chapter 1).

⁵⁹ FairPensions Seminar, June 2010, ‘Prudence Redefined’

“ Respondents to FairPensions’ 2009 survey of fund managers identified short-termism as a key barrier to integration of climate risk ”

The problem of short-termism: from diagnosis to cure

It has often been said that short-termism militates against effective consideration of ESG issues. Many ESG issues - such as climate change - constitute material risks in the medium- to longer-term.⁶⁰ Respondents to FairPensions’ 2009 survey of fund managers identified short-termism as a key barrier to integration of climate risk. One fund manager said that *“the most significant barrier is the imbalance between the relatively short term horizons of mainstream investment analysis and the relatively long term nature of the material business impacts of climate change.”*⁶¹

More generally, short-termism has been recognised as a problem since long before the financial crisis: the post-crisis Walker Review echoes almost exactly the concerns raised by the Myners Report nearly a decade earlier, which itself noted that these concerns were not new.⁶² Myners also questioned the persistence of benchmark-relative performance mandates, noting in particular that

*“the peer group benchmark approach leads to a distorted system of asset allocation under which a historic industry consensus is the main driver of industry decisions. Such a system serves the interests of beneficiaries poorly.”*⁶³

Yet little seems to have changed. It is easy to repeat the now well-rehearsed conclusion that pension fund mandates must change in order to ensure that fund managers’ incentives are aligned with the long-term best interests of beneficiaries. As the government initiates a further review on economic long-termism,⁶⁴ there is a need to more seriously consider why, if this shift is so clearly in the long-term interests of funds and their beneficiaries, it has yet to take place.

Pension funds themselves are quick to agree that change is needed. In a 2008 study of European pension funds, there was very high agreement that most investors act in too short-term a manner, and that short-term, benchmark-relative remuneration structures were partly to blame for this.⁶⁵ In one sense, this is hardly surprising, since the funds surveyed are described as *“European pioneers with regard to the integration of sustainability aspects in the investment process”*.⁶⁶ But this makes it all the more striking that they estimated their own funds’ ideal investment horizon at 23 years, and their *actual* investment horizons at just six years.⁶⁷ In other words, pension funds recognise the problems, but are still struggling to adopt solutions.

⁶⁰ See for example Mercer, 2011, ‘Climate Change Scenarios - Implications for Strategic Asset Allocation’, Executive Summary ⁶¹ Henderson Global Investors. FairPensions, 2009, ‘Preparing for the Storm? UK fund managers and the risks and opportunities of climate change’, p8. ⁶² Myners, P. 2001, ‘Institutional investment in the UK: A review’ (HM Treasury), esp paras 51-53; Walker, Sir D., 2009, ‘A review of corporate governance in UK banks and financial industry entities’, esp paras 1.13-1.14 ⁶³ Myners, P. 2001, ‘Institutional investment in the United Kingdom: A review, para 3.55 (p61) ⁶⁴ BIS, 2010, ‘A long-term focus for corporate Britain’ ⁶⁵ Hesse, 2008, ‘Long-term and sustainable pension investments: A study of leading European pension funds’ ⁶⁶ Ibid, p10 ⁶⁷ Ibid, p22

Again, this can to some extent be seen as a collective action problem: the notion of prudence as a duty to herd creates an unwillingness to 'jump first' by diverging so fundamentally from established practice.⁶⁸ But this is not the whole story. Pension funds that are struggling with enormous deficits are under significant pressure to maintain short-term results - particularly in defined benefit schemes, where failing to do so may result in the employer closing the scheme. Some commentators have also placed blame at the door of triennial valuations using 'mark-to-market' accounting - whereby a pension fund is valued based on a snapshot of its assets and liabilities at a particular point in time. There is also a need for funds to have confidence in the availability of alternative models of evaluating and remunerating fund managers which ensure they are delivering value.

In this context, pension funds cannot simply be told to change their mandates and left to get on with it. The role of government is three-fold: to act as a catalyst for action to help overcome collective action problems; to identify practical and regulatory barriers to longer-term outlooks and assist funds to overcome them; and to encourage the development of practical alternative models. This could include supporting the work of existing organisations in developing practical solutions, such as the International Corporate Governance Network's Model Mandate Initiative.⁶⁹

Recommendation: Pension providers should consider how they can embed appropriate incentives in their contracts with asset managers - for instance, by incorporating longer-term performance measures on a wider range of factors than benchmark relative financial performance. As part of the review 'A long-term focus for corporate Britain', BIS should seek to facilitate this process, for example through a 'lab' enabling experimentation as to the practical form such mandates might take.

Active passive investors

Finally, there is a need to overcome the perception that ESG is about screening, and therefore an irrelevant consideration for investors who track indices. 'Passive' investments account for around 20% of all assets managed by UK fund managers; the proportion of equities managed in this way is significantly higher.⁷⁰ Passive investors can still exercise choice over the indices they track, including from an increasing range of indices that take ESG issues into account, such as the Dow Jones Sustainability Index. More crucially, they still possess rights as shareholders to engage with their investee companies about their ESG performance with a view to enhancing value. Both the UK Stewardship Code for institutional investors⁷¹ and its predecessor, the ISC Statement of Principles on shareholder engagement,⁷² emphasise that "*intervention should be considered*

⁶⁸ See Woods, C. forthcoming, 2011, *op cit*. ⁶⁹ ICGN, 31 Jan 2011, 'ICGN Model Mandate Initiative: Model contract terms between asset owners and their fund managers: Call for Evidence'. ⁷⁰ BIS, 2010, *A long-term focus for corporate Britain*, Section 4.6 ⁷¹ FRC, 2010, 'The UK Stewardship Code', Principle 4, p7 ⁷² ISC, 2007, 'Statement of Principles on the responsibilities of institutional investors and agents', Principle 4

“There is a need to overcome the perception that ESG is about screening, and therefore an irrelevant consideration for investors who track indices”

regardless of whether an active or passive investment policy is followed.” More recently, the UNPRI has published guidance on the implementation of Responsible Investment principles in a passive investment context.⁷³ It notes that 17% of its signatories’ assets were passively managed in 2009.

Indeed, exercising ‘voice’ through engagement is if anything more important for passive investors, since they do not have the option of ‘exit’: constructive engagement is the only lever by which they can seek to enhance the value of their portfolio. An understanding of the ways in which ESG issues may be material to the long-term success of a company is therefore just as essential for passive investors as for active managers. Indeed, L&G, the UK’s largest passive manager, is well known for its robust approach to engagement on governance issues. In addition, the new National Employment Savings Trust (NEST) appears on course to embed ESG engagement into its passively-managed default fund option.⁷⁴ This provides a useful model for funds wishing to combine the advantages of Responsible Investment with the low charges associated with passive management.

Chapter Summary

A range of factors were identified as contributing to the slow penetration of the Freshfields view of fiduciary duty into the mainstream, including lack of clarity over responsibilities within the investment chain, perceived difficulties with quantifying the materiality of ESG issues and lack of adequate reporting from companies. However, the most critical barriers were identified as:

- Perverse incentives. The persistence of short-term, benchmark-relative remuneration structures based solely on financial performance creates little incentive for fund managers to devote resources to ESG integration.
- Legal uncertainty. Lack of authoritative guidance on non-financial issues contributes to a perception among trustees that it is safest to avoid this area altogether. Meanwhile, prevailing interpretations of the fiduciary duty of prudence exacerbate herding behaviour and fear of deviating from the status quo.
- Cultural misconceptions. There appears to be a lingering perception of ESG as a client-driven ethical preference rather than an integral part of mainstream financial analysis.

⁷³ UNPRI, January 2011, ‘Responsible Investment in Passive Management Strategies: Case Studies & Guidance’

⁷⁴ For example, in February 2011 the scheme tendered for Responsible Ownership and ESG data services.

Summary of Recommendations

- **DWP** should ensure that any new guidance for trustees provides confirmation that fiduciaries should consider ESG issues which may be financially material. This could be accompanied by more detailed guidance on the respective roles of trustees, asset managers and consultants
- **Pension providers** should consider how they can embed appropriate incentives in their contracts with asset managers - for instance, by incorporating longer-term performance measures on a wider range of factors than benchmark relative financial performance. As part of the review 'A long-term focus for corporate Britain', **BIS** should seek to facilitate this process, for example through a 'lab' enabling experimentation as to the practical form such mandates might take.
- The **FRC** should ensure that future revisions of the Stewardship Code place explicit emphasis on environmental and social issues as well as on governance.
- **Companies** should integrate environmental and social information into their reporting, including narrative reports. As part of its review of narrative reporting, **BIS** and the **FRC** should seek to promote the concept of integrated reporting and should explicitly clarify the need to ensure that environmental and social reporting is forward-looking and strategic rather than being siloed into backward-looking CSR or sustainability reports.

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Chapter

Beyond Financial Interests

Can trustees consider beneficiaries' ethical and social interests?

“ I am not asserting that the benefit of the beneficiaries which a trustee must make his paramount concern inevitably and solely means their financial benefit, even if the only object of the trust is to provide financial benefits... ‘Benefit’ is a word with a very wide meaning, and there are circumstances in which arrangements which work to the financial disadvantage of a beneficiary may yet be for his benefit¹ ”

Cowan v Scargill, 1984

Fiduciary obligation requires trustees to act in the ‘best interests’ of their beneficiaries - but what does ‘best interests’ mean? Is it restricted solely to securing the best financial return, or can trustees take into account beneficiaries’ other interests - for instance, in seeing their ethical values reflected in their investments, or in securing a high future standard of living and a healthy environment?

Over the past decade there has been a steady expansion of consumer interest in ‘ethical investment’. By June 2010, British green and ethical retail funds had risen to £9.5bn in value, representing around 750,000 investors - a three-fold increase since 1999.² In 2009 alone, the total amount of money invested in all ethical financial products in the UK grew by 34% - far outstripping growth in the mainstream finance market.³ This picture is replicated internationally, with a recent survey finding that the amount invested into US and Australian ‘socially responsible investment’ (SRI) strategies last year grew faster than the market as a whole.⁴

Consumer interest in ethical pension products is also on the rise. In a government-commissioned survey of the target market for NEST, the new government-backed pension scheme, around a quarter of respondents said they would invest in an ethical fund regardless of the return,⁵ and almost half said they would invest in an ethical fund if it did not involve a sacrifice of return. This interest was reflected in NEST’s recently-announced decision to offer its members

“ In 2009 alone, the total amount of money invested in all ethical financial products in the UK grew by 34% - far outstripping growth in the mainstream finance market ”

the option of an ethical fund.⁶ Although the number of UK defined contribution (DC) schemes offering an ethical option has increased significantly in recent years, more than half of all schemes still choose not to do so.⁷

This chapter asks whether fiduciary obligation as it currently stands presents a barrier to the consideration of social, environmental and ethical issues. It concludes that the legal position is murky, in part due to a lack of authority, and that statutory clarification may be needed to free trustees from perceived restrictions on their exercise of judgement. However, it also suggests that the authority which does exist is much misunderstood. Nowhere is it stated that fiduciary obligation amounts to a blanket ban on considering non-financial issues for their own sake, as many appear to believe. Instead, trustees’ duties are about taking reasonable and properly informed decisions on the basis of all relevant factors, and beneficiaries’ ethical or social interests may be a legitimate factor for them to weigh in the balance.

² EIRIS, 1 June 2010, ‘UK ethical investment hits record high of £9.5 billion’. <http://www.eiris.org/media.html#marketstats2010> ³ Independent, 7 November 2010, ‘Ethical savings: Cash investors find the returns are comparable’. ⁴ Responsible Investor, 19 November 2010, ‘SRI asset growth in Australia and US outstrips mainstream market’ ⁵ HOC Debate 14 Dec 2010: Col 886; PADA, May 2009, ‘Building personal accounts: designing an investment approach’, p119. ⁶ IPE, 21 Dec 2010, ‘NEST to tender SRI mandate, confirms ethical investment option’. ⁷ Dobson, C. and S. Horsfield, 2009, ‘Research Report #608, Defined contribution pension provision’, DWP.

Non-financial best interests: the legal position

The Freshfields view - that considering financially material ESG issues is consistent with fiduciary duty - seems hard to refute from a legal perspective. As we saw in chapter 3, the barriers to widespread uptake of this approach lie elsewhere. The same cannot be said for the validity of 'ethical' considerations. Here, the law is deeply ambiguous and fiercely contested.

There is no UK statute explicitly dealing with fiduciaries' latitude to invest ethically, and very little relevant case law. One result of this has been a heavy reliance on a small number of cases. The most famous of these -Cowan v Scargill⁸ -did not concern an 'ethical' investment policy at all, but a union-led policy of support for the British coal industry. The judge himself (Sir Robert Megarry) has since said that his judgement should not be interpreted as a blanket prohibition of ethical investment.⁹ Nonetheless, given its enormous influence on the debate about ethical investment, this judgement is perhaps the best place to start in examining the current law.

Box A: Cowan v Scargill

This case concerned the mineworkers' pension scheme. The five trustees appointed by the National Union of Mineworkers (NUM), led by Arthur Scargill, refused to approve an investment plan for the trust unless it excluded all overseas investments and all investments in industries directly competing with coal (e.g. oil and gas). The court upheld the employer-nominated trustees' contention that this was a breach of fiduciary duty, as:

- The trustees were motivated by their personal views¹⁰ and by a desire to pursue union policy,¹¹ and were not putting the beneficiaries first
- Many of the beneficiaries (such as widows and dependants) would not be directly affected by the health of the mining industry, but would suffer any negative impacts from the likely sacrifice of return entailed by the proposed policy¹²
- In any case, the social benefits of the policy were too speculative and remote: the pension fund's assets were nowhere near large enough to have any material impact on the prosperity of the mining industry¹³ or the national economy.¹⁴

8 [1984] All ER 750; [1985] Ch270. Page 760. 9 Megarry, 'Investing Pension Funds: The Mineworkers Case', Youdan (ed), 1989, *'Equity, Fiduciaries and Trusts'*. Toronto: Carswell 10 Ibid page 761c 11 Ibid page 766a 12 Ibid page 764h 13 Ibid page 764j 14 Ibid page 767c

In particular, *Cowan v Scargill* contains what is probably the most-quoted judicial comment on the meaning of ‘best interests’ in an investment context:

*“when the purpose of the trust is to provide financial benefits for the beneficiaries... the best interests of the beneficiaries are normally their best financial interests.”*¹⁵

As such, investment powers must normally be exercised so as to secure the best return for the beneficiaries at a given level of risk.

This is often invoked as proof that the consideration of ethical issues by trustees will always be unlawful, and that ‘best interests’ must always and only mean ‘best financial interests’. Yet the judgement explicitly contradicts this interpretation, going on to say:

*“I am not asserting that the benefit of the beneficiaries which a trustee must make his paramount concern inevitably and solely means their financial benefit, even if the only object of the trust is to provide financial benefits ... ‘Benefit’ is a word with a very wide meaning, and there are circumstances in which arrangements which work to the financial disadvantage of a beneficiary may yet be for his benefit.”*¹⁶

This explicitly establishes the principle that non-financial benefits may be a legitimate factor for trustees to weigh in the balance - and, in certain circumstances, may outweigh the financial interest in a higher return.

As critics of ethical investment are quick to point out, the judge went on to say that such cases are likely to be very rare. The example he gave was of a trust in which all beneficiaries were adults with strict moral views, who *“might well consider that it was far better to receive less than to receive more money from an evil and tainted source”*.¹⁷ This level of unanimity can never in practice be satisfied in a pensions context,¹⁸ and so trustees could not rely on this example to justify an ethical investment policy that was financially disadvantageous.

But what if no sacrifice of financial return is involved? As Megarry put it, *“If the investment in fact made is equally beneficial to the beneficiaries, then criticism would be difficult to sustain in practice, whatever the position in theory.”*¹⁹ He elaborated on this when, unusually, he revisited the case in a symposium paper.^{20/21} The paper noted that the NUM trustees had insisted on an absolute ban on investment overseas and in oil, and speculated on whether the outcome of the case might have been different if they had instead stipulated that ‘all other things being equal’ such investments should not be made (ie. if another investment of equal merit was available). In relation to oil, Megarry concluded that *“a strong case could probably be put together for contending that no demonstrable harm could come to any beneficiary by adopting a policy based on a qualified restriction of this kind.”* More generally, where two investment options were of equal value, he posited

¹⁵ [1984] All ER 750; [1985] Ch 270. Page 760. ¹⁶ Page 761 ¹⁷ Ibid P761 h & j ¹⁸ Because there will always be contingent beneficiaries who are unascertained and/or minors who cannot give a valid consent. See Scanlan, C. 2010, ‘Best Interests Redefined: Background Paper’, available online at http://www.fairpensions.org.uk/sites/default/files/uploaded_files/CharlesScanlanBestInterestsLong.pdf. p11 ¹⁹ Ibid p761b ²⁰ See footnote 7 ²¹ Megarry’s paper also suggested that schemes could resolve the kind of problems which arose in *Cowan v Scargill* by making use of scheme drafting and amendment powers. Our third seminar considered whether this might be an as yet untapped avenue for pension scheme reform. Lawyers present concluded that scheme amendment powers might be a solution for ‘second order’ problems, such as providing for member consultation, but could not be used to restrict trustees’ investment powers in ways not envisaged by the original trust deed. In the case of a new scheme, the scope of scheme drafting powers is much broader, although still not entirely unlimited (for instance, drafters must comply with regulatory requirements such as the duty to maintain a diversified portfolio).

that it may indeed “*be for the benefit of the beneficiaries at large*” to choose one in accordance with the ethical preference of a majority of beneficiaries.

This idea has become known as the ‘ethical tie-break’: trustees may make a decision on ethical grounds between two options that are equally financially advantageous. US regulatory guidelines have formalised this principle by stating that, where two or more alternative investments “*are of equal economic value*”, fiduciaries are permitted to “*choose between the investment alternatives on the basis of a factor other than the economic interest of the plan.*”²² In the UK, regulatory guidance is less clear cut. Former guidance issued by The Pensions Regulator (and its predecessor) confirmed that scheme trustees could “*consider non-financial matters when comparing investments with the same potential return.*” The current guidance does not restate this principle, although it is understood that this does not reflect any intention to move away from the tie-break principle. But how does this ‘ethical tie-break’ work in practice?

The ‘Ethical Tie-Break’

In line with the emphasis of fiduciary obligation on process, the ‘tie-break’ refers to the information available to trustees at the time they are making the decision, rather than to the investment outcome. This is explicitly incorporated into US regulatory guidelines: in order to ensure compliance with the regulations, trustees must have “*a written record demonstrating that a contemporaneous economic analysis showed that the investment alternatives were of equal value*”.²³ The UK courts have also held that it is process, not outcome, that matters when determining the legality of ethical

“*It is process, not outcome, that matters when determining the legality of ethical investment*”

investment. In the case of *Martin v City of Edinburgh District Council*, where a Conservative councillor sued his Labour colleagues for implementing a policy of disinvestment from apartheid-era South Africa, the judge ruled that the councillors had failed in their fiduciary duty because they had not undergone due process and taken proper advice. But he stressed that had they done so, they might well have arrived at the same policy: indeed, the fund’s performance actually improved after the policy was implemented.²⁴ Conversely, as the Charity Commission has put it, “*Trustees are unlikely to be criticized for adopting a particular policy if they have considered the correct issues, taken appropriate advice and reached a rational result.*”²⁵ In principle, this also applies to pension fund trustees.

Is the tie-break plausible?

Some critics have objected that the tie-break scenario is inherently flawed because it will simply never arise. Since modern portfolio theory requires trustees to compare not only the expected risk and return of a given asset but also its covariance with the rest of the portfolio, it will always be possible to distinguish between two investment options on financial grounds.²⁶ A reduction in the investment universe is always financially disadvantageous, the argument goes, since it limits trustees’ ability to diversify: “*any*

²² US Dept of Labor, October 2008, ‘ETI’ Interpretive Bulletin, 29 CFR 2509.08-1 ²³ US Dept of Labor, ‘ETI’ Interpretive Bulletin, October 2008, 29 CFR 2509.08-1 ²⁴ *Martin v City of Edinburgh District Council* [1988] SLT 329, [1988] SCLR 90 ²⁵ Charity Commission, 2010, ‘Draft guidance on Charities and Investment Matters’, p34 ²⁶ Thornton, R. ‘Ethical Investments: A Case of Disjointed Thinking’, *Cambridge Law Journal*, 67(2), July 2008, at p405

restriction adopted on ethical or other grounds will necessarily have an effect, however small, upon efficiency.”²⁷

There are various problems with this argument - but one key issue lies in the caveat, ‘however small’. Critics of the tie-break assume that it requires two alternative investments to be exactly equivalent (and that, even in that unlikely event, the ‘right’ answer is to diversify by splitting the investment equally).²⁸ But what matters to savers - and therefore to their fiduciaries - is whether a given investment strategy will *significantly* or *materially* affect the performance of the fund.²⁹ This changes the picture enormously, since it is clearly possible to construct two or more potential portfolios whose projected performance would not be materially different. Likewise, it is possible to test the accuracy of such projections by subsequent analysis. To take a practical example, the Norwegian State Pension Fund, a noted ethical investor, modelled the retrospective performance of its portfolio against a hypothetical portfolio in which the stocks it had screened out for ethical reasons were reinstated, and found no statistically significant difference.³⁰ Similarly, in a study by wealth management firm GHC, ‘virtual’ ethical portfolios significantly outperformed the market over a one-year period.³¹

Research suggests that 75-95% of a portfolio’s variability can be attributed to asset allocation rather than stock selection.³² As such, the practical effect of substituting one individual asset for another on ethical grounds is likely to be negligible. Even the exclusion of whole sectors can often be compensated for by weighting the rest of the portfolio so as to minimise any increase in risk (see p8).

“ Research suggests that 75-95% of a portfolio’s variability can be attributed to asset allocation rather than stock selection. As such, the practical effect of substituting one individual asset for another on ethical grounds is likely to be negligible ”

Indeed, as the Freshfields report argued, recognition of modern portfolio theory may actually *increase* trustees’ latitude to make ethical decisions, precisely because it implies a more holistic view: trustees’ duty is to construct a balanced and sensible *portfolio*, rather than simply to compare two individual *assets* and choose the best-performing.³³

Legal interpretations of the tie-break

Although there is little English authority specifically on point, this more common-sense interpretation of the tie-break has some support in legal precedent. For instance, an ethical screening policy that excluded 13% of UK listed companies by value has been ruled to be consistent with trustees’ fiduciary duties (see Box B). This judgement concerned a charitable trust and was partly based a charity’s right to avoid investments that conflict with its charitable aims. As such it can only cautiously be applied to pension funds. However, it has been pointed out that the judge also implied the policy

²⁷ Ibid, p407 ²⁸ Ibid, p406 ²⁹ On this see also Mansley, M. 2000, ‘Socially responsible investment: A guide for pension funds and institutional investors’, Monitor Press, p16 ³⁰ Norwegian Ministry of Finance, Report No 20 (2008-2009) to the Storting, ‘On the Management of the Government Pension Fund in 2008’, Section 4.3.4.4 (Box 4.4). Available at <http://bit.ly/hPSGoN> ³¹ Citywire, Nov 4th 2010, ‘Evidence that ethical portfolios can outperform’. ³² Brinson et al, 1991, ‘Determinants of Portfolio Performance II: An Update’, Financial Analysts Journal vol 47, no. 3 (May/June): 40-48; Ibbotson, ‘The Importance of Asset Allocation’, Financial Analysts Journal Vol 66 No 2 (March/April 2010) ³³ UNEP-FI, 2005, ‘A legal framework for the integration of environmental, social and governance issues into institutional investment’, p82

was compatible with general fiduciary investment criteria,³⁴ since the exclusions still left open “an adequate width of alternative investments.”³⁵ This would support the idea that the tie-break principle could indeed be used to justify the exclusion of certain investments on the basis that financially satisfactory alternatives were available.

A US state court took a similarly nuanced approach in ruling that divestment from apartheid-era South Africa was consistent with fiduciary obligations since it would cause only a minimal loss:

*“Given the vast power that pension trust funds exert in American society, it would be unwise to bar trustees from considering the social consequences of investment decisions in any case in which it would cost them even a penny more to do so.”*³⁶

More generally, English law clearly enshrines the principle that fiduciary duty is about the prudent exercise of trustees’ discretion. Arguments against the ethical tie-break often seem to imply that there exists one objectively optimal portfolio, identifiable through particular risk assumptions and mathematical calculations, and that any fiduciary investors not holding this exact portfolio may be in breach of their fiduciary duties. On this basis, fiduciary obligations might be better discharged by machines than by human beings. This obscures the essential nature and basic purpose of fiduciary obligation: to ensure that those entrusted with the interests of others make decisions which are reasonable, properly considered and motivated by the welfare of the beneficiaries.

“The fulfilment of fiduciary duties is not determined quantitatively, by asking whether trustees made the objectively ‘correct’ decision, but qualitatively, by asking whether their decision-making process was sound”

In *Martin v City of Edinburgh District Council*, the judge explicitly rejected the plaintiff’s claim that *Cowan v Scargill* required trustees “merely to rubber-stamp the professional advice of financial advisors.” On the contrary, he said:

*“I cannot conceive that trustees have an unqualified duty... simply to invest trust funds in the most profitable investment available. To accept that without qualification would, in my view, involve substituting the discretion of financial advisers for the discretion of trustees.”*³⁷

In other words, the fulfilment of fiduciary duties is not determined quantitatively, by asking whether trustees made the objectively ‘correct’ decision, but qualitatively, by asking whether their decision-making process was sound. As UNEP’s 2009 report observed,

*“The courts accept, despite the widespread use of mathematical modelling, that investment is an art rather than a science and that there is a wide spectrum of opinion.”*³⁸

³⁴ Thornton, 2008, op cit, p407 (NB Thornton disagreed with the judgement in this respect, for the reasons outlined above). ³⁵ [1993] 2 All ER p308b ³⁶ Board of Trustees of Employee Retirement System of Baltimore (City) v Baltimore (City), 62 317 Md. 72, 562 A.2d 720 (1989) ³⁷ *Martin v City of Edinburgh District Council* 1988 SLT 329, 1988 SCLR 90, p9 ³⁸ UNEP-FI, 2009, ‘*Fiduciary Responsibility: Legal and practical aspects of integrating environmental, social and governance issues into institutional investment*’. p28 ³⁹ On this see also Mansley, M. 2000, op cit, p15

Indeed, the apparent fallibility of many portfolio models, exposed by the financial crisis, could be seen as reinforcing the need for trustees to retain their independent judgement. In conclusion, a properly-motivated ethical investment policy which does not compromise beneficiaries' financial interests does appear to be possible, both legally and in practice.

Implications for trustees

Of course, this does not mean that any given ethical screen would necessarily pass the tie-break test. Much will depend on the characteristics of the fund in question: a fund with long-term horizons might be able to tolerate some short-term volatility, whilst a fund struggling to meet its short-term liabilities might not. In a defined benefit scheme, the employer might have a legitimate interest- since, if such a policy did result in loss, the beneficiaries would receive the same pension regardless while the employer would bear the cost.³⁹ Excluded sectors might have particular characteristics which would need to be taken into account: for instance, tobacco is a 'defensive' stock, resilient to the effects of recession due to its addictive nature. A fund that excluded tobacco would therefore need to consider how to compensate for this, for instance by holding more shares in other defensive stocks, such as food companies.

What does seem clear is that trustees' fiduciary obligation consists in weighing up these various factors, analysing the effect of a given ethical investment policy, and making a prudent, informed decision on that basis. Yet this is far from being the attitude to ethical investment that prevails today. Fund members who express concern about an ethical issue are routinely dismissed out of hand, being told that

fiduciary duty precludes any consideration of their concerns. As we have seen, there are compelling arguments that this is not the legal position. If trustees have reason to believe there is a significant non-financial interest among their members in a particular ethical issue, they may be entitled - perhaps even required - to consider whether this interest can be accommodated without compromising members' financial best interests.

Screening vs Engagement

The idea of the ethical tie-break - like most of the debates around ethical investment - assumes a policy of positive or negative screening, whereby particular stocks or sectors are chosen or avoided based on their ethical characteristics. Common examples might be the exclusion of arms or tobacco, or positive investment in green technology. The possibility of shareholder engagement on ethical issues is less often discussed. A de facto split seems to have evolved whereby engagement is largely the preserve of 'business-case RI' (discussed in chapter 3), whilst ethically-motivated investment is assumed to involve screening. There seems no obvious reason why this should be the case, and many of the issues explored in this chapter are equally applicable to an engagement-based approach.

Recommendation: *Pension funds, when asked by members to consider an ethical issue, should perform an analysis of its effect on their portfolio, in line with the 'ethical tie break' principle. Currently many funds wrongly invoke fiduciary obligation to justify a refusal even to consider a non-financial issue.*

⁴⁰ Re Clore's Settlement's Trusts [1966] 2 All ER 272. Scanlan, C. 2010, *op cit*, p14 ⁴¹ One participant at our seminar who is heavily involved with the industry commented, 'My impression would be almost none do it.' ⁴² See Richardson, B.J. 'From Fiduciary Duties to Fiduciary Relationships: Responding to the Will of Beneficiaries,' *Journal of Sustainable Finance and Investment* (2011) 1: 1-15 ⁴³ UNEP-FI, 2005, *op cit*, p12 ⁴⁴ Austin W Scott, 1967, *The Law of Trusts*,

One man's ethics...

How, though, are members' non-financial interests to be determined? One common objection to the idea of ethical investment is that ethics is inherently subjective, making it impossible for trustees to decide which ethical issues to take into account.

Beneficiaries' views

Legally, trustees should base an ethical investment policy on some assessment of beneficiaries' ethical preferences, as opposed to their own personal views. As Charles Scanlan noted in his paper for our third seminar, case law confirms that *“for a moral benefit to be taken into account in the exercise of a trustee's discretion, it must be one which the beneficiary recognises, not one attributed to him or her by the trustees.”*⁴⁰

This is a very different idea of ethical investment from that usually entertained by its critics - of trustees indulging their personal views at the expense of beneficiaries. Instead, it is rooted in the recognition that beneficiaries have non-financial interests which trustees may legitimately take into consideration. Although more in line with the legal position, this approach does not seem to be widespread even among those funds that do have ethical policies. Very few pension funds inquire into their beneficiaries' preferences.⁴¹ Research suggests that contract-based vehicles, such as SRI mutual funds, also rarely consult with their customers.⁴² Given the wide range of ethical funds available, this is cause for concern. If the only ethical option provided by a pension scheme is a 'deep-green' fund with much lower returns or higher volatility, and this option is not

rooted in any assessment of members' preferences, it may not be serving either members' financial or their non-financial best interests. The question of how beneficiaries' views can be ascertained in practice, and the degree of consensus which is required before they may be taken into account, is considered in detail in the next chapter.

Social norms

Some legal commentators have also suggested that trustees can legitimately avoid investments that breach widely recognised norms, such as conventions on the elimination of child labour,⁴³ or fundamental ethical principles, such as racial equality.⁴⁴ Such universal norms, it is argued, can reasonably be taken as a proxy for beneficiaries' will if it has not been possible to consult them.

Indeed, as the Freshfields Report noted, fiduciary duty has always evolved to reflect changing social norms. An interesting example is the case of *Roberts v Hopwood* (1925), in which a court found that a council's policy of paying men and women equally for the same work was a breach of its fiduciary duty to ratepayers. The council had, said the judge, *“allowed themselves to be guided in preference by some eccentric principles of socialist philanthropy, or by a feminist ambition to secure the equality of the sexes in the matter of wages in the world of labour.”*⁴⁵ Even leaving aside the fact that gender discrimination is now illegal,⁴⁶ the social acceptance of gender equality makes it highly unlikely that such a policy would be considered a breach of fiduciary obligations today.

This highlights a concern raised by Professor Benjamin Richardson about reliance on widely accepted norms: that it prevents socially responsible investors from being at the vanguard of social change, allowing them to act only when the battle for some ethical principle has already been conclusively won. Richardson argues that *“historically, the very purpose of SRI was to be a means by which ethical investors would act when governments had failed to do so.”*⁴⁷ Nonetheless, if investors felt free to take a position on the large number of practices which are widely accepted as unethical but which still persist - such as torture or child labour - it would be a significant advance on the status quo.

Recommendation: *DC schemes should offer an ethical option based on an assessment of members’ ethical preferences*

Continuing uncertainty

Over the years there have been several calls for clarification of the legal position on ethical investment. The government has always shied away from putting anything in statute: regulatory change has been limited to the requirement, introduced in 2000, that pension fund trustees disclose in their Statement of Investment Principles *“the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments.”*⁴⁸

It seems clear that the government’s intention here was to encourage ethical investment. The intent to introduce these regulations was first announced by John Denham in a lecture at UKSIF (then the UK

Social Investment Forum) entitled ‘Building a Better World’.⁴⁹ The Pensions Minister at the time the regulations were made, Stephen Timms, has since described the measure as *“a light touch intervention”* which has *“become a landmark regulation, effectively catalysing ethical investment in the UK.”*⁵⁰

In 2008, renewed pressure to clarify the situation led government minister Lord McKenzie to state in a parliamentary debate that:

*“There is no reason in law why trustees cannot consider social and moral criteria in addition to their usual criteria of financial returns, security and diversification. This applies to the trustees of all pension schemes.”*⁵¹

These developments might have been expected to remove any doubt that taking ethical considerations into account can be lawful. Yet they seem to have been no substitute for full statutory clarification. Neither purported to change the pre-existing law, and doubt as to the legal position continues to persist. In a study for NEST, one pension scheme officer asserted, *“We cannot screen on an ethical basis alone, that falls outside our fiduciary responsibilities and could leave us open to challenge.”*⁵²

Perhaps because of this radical uncertainty and confusion, ‘business-case Responsible Investment’ appears to have largely displaced ‘ethical investment’ in mainstream pensions discourse. The fact that business-case RI often pitches itself as being consistent with fiduciary duty, in contrast with traditional ethical investment, has only served to reinforce the questionable assumption that taking

⁴⁷ Richardson, B.J. 2011, *op cit* ⁴⁸ Regulation (11A) of SI 1996/3127, inserted by SI 1999/1849. The wording is now to be found in regulation 2(3)(b)(vi) of The Occupational Pension Schemes (Disclosure of Information) Regulations 2005 (SI 2005/3378). ⁴⁹ UKSIF Annual Lecture, July 1998, ‘Building a Better World: The Role of Socially Responsible Pensions’ ⁵⁰ Stephen Timms, 10 Nov 2009. Speech for National Ethical Investment Week. ⁵¹ Hansard, HL Deb, 7 Oct 2008: Col 180 ⁵² Cox, P., 2009, ‘Responsible investment in fund management: it works, but when?’ Available online at <http://www.nestpensions.org.uk/documents/responsible-investment-in-fund-management-final-report.pdf>

non-financial issues into account for their own sake is unlawful.

Ultimately, despite the significant practical progress that has been made, the debate over the legality of ethical investment has scarcely moved on in the last thirty years. There is a clear case for statutory clarification to end this confusion. As Charles Scanlan's paper concluded: "It seems unlikely that there will be any change in the Cinderella status of ethical investment unless the current uncertainties about its legal status are resolved."⁵³

One interesting precedent comes from the Canadian province of Manitoba, which in 1995 passed a law stating that:

*"Subject to any express provision in the instrument creating the trust, a trustee who uses a non-financial criterion to formulate an investment policy or to make an investment decision does not thereby commit a breach of trust if, in relation to the investment policy or investment decision, the trustee exercises the judgement and care that a person of prudence, discretion and intelligence would exercise in administering the property of others."*⁵⁴

“Ultimately, despite the significant practical progress that has been made, the debate over the legality of ethical investment has scarcely moved on in the last thirty years. There is a clear case for statutory clarification to end this confusion”

Recommendation: Statutory clarification is needed on the extent to which ethical and social considerations can be taken into account by pension trustees in order to end current confusion and disagreement, as well as over-reliance on often questionable interpretations of a small number of legal decisions with doubtful relevance to contemporary circumstances. Chapter 6 provides a possible template.

⁵³ Scanlan, C. 2010, *op cit.* p9 ⁵⁴ Section 79.1, Trustee Act SM 1995

Box B: The legal position for charities

Charities have somewhat greater latitude than pension funds when it comes to ethical investment, in recognition of their underlying charitable aims (although whether this principle should necessarily be restricted to charities is considered on page 89-90 below).

In the leading case, **Bishop of Oxford vs Church Commissioners**, an SRI policy was challenged for being insufficiently ethically stringent. The Bishop of Oxford argued that the Church of England's policy of 'taking account of' social, ethical and environmental issues was "*guided too rigorously by purely financial considerations*" and that it should instead give overriding weight to "*the underlying purpose for which they hold their assets... the promotion of the Christian faith*".⁵⁵

The court rejected this argument, but explicitly upheld the legality of the Church's *existing* ethical investment policy, which excluded 13% of UK listed companies by value (namely armaments, gambling, alcohol, tobacco, newspapers and South African companies) and committed to seek out "*investments which respond positively to specific areas of concern in our society*".⁵⁶ The judge ruled that this policy still left open "*an adequate width of alternative investments*".⁵⁷ By contrast, the Bishop's proposed

policy would have excluded 37% of UK listed companies by value: this would not have been prudent, since the resulting portfolio would have been "*much less balanced and diversified*".⁵⁸

The judgement also established particular circumstances in which charities may invest ethically even if it causes them to lose money:

- If investments of a particular type "*would conflict with the aims of the charity*", they may be avoided "*even if it would be likely to result in significant financial detriment to the charity*".⁵⁹
- If investments might "*hamper a charity's work*" by putting off potential donors or beneficiaries, these disadvantages must be balanced with the financial detriment associated with excluding the investments.
- If the trust deed provides for the trustees to take non-financial considerations into account, they are entitled and even required to do so.⁶⁰

These principles can now be found in Charity Commission guidance.⁶¹ This guidance was being revised at time of writing with the intention of giving charities more leeway to make investments which further their charitable aims.⁶² Notwithstanding criticisms that the existing guidance may be too restrictive or confusing,⁶³ it is unfortunate that no similar guidance exists for pension fund trustees.

⁵⁵ [1993] 2 All ER p302 ⁵⁶ Ibid p307 ⁵⁷ Ibid p308b ⁵⁸ Ibid p308h ⁵⁹ Ibid p304 ⁶⁰ Ibid p305 ⁶¹ The Charity Commission, CC14, 'Investment of Charitable Funds: Basic Principles' ⁶² The Charity Commission, 13 Dec 2010, 'Consultation: Charities and Investment Matters' ⁶³ See for example Rathbone Greenbank Investments, April 2009, 'Comments on the Charity Commission guidance on ethical investment'.

Quality of life: social and environmental ‘best interests’

“Many people wonder what good an extra percent or three of patrimony are worth if the society in which they are to enjoy retirement and in which their descendents will live deteriorates. Quality of life and quality of the environment are worth something, even if not, or particularly because, they are not reducible to financial percentages.”⁶⁴

Foreword, the Freshfields Report

‘Non-financial interests’ are not limited to ethical interests, although this has tended to dominate the debate. So can trustees take account of beneficiaries’ other non-financial interests - including social and environmental factors which may affect their quality of life?

This is not a question of whether pension funds should consider the wider interests of society or the public interest (explored in Chapter 6), but of whether they are free to consider the wider social interests of *their beneficiaries*.⁶⁵ The relative lack of attention given to this area is somewhat surprising - particularly given that social rather than ethical benefits were the focus in *Cowan v Scargill*. As we have seen, the proposed policy was rejected not because social benefits were illegitimate considerations, but on particular grounds specific to the facts of the case (explored further below). The UK government also seemed to recognise the legitimacy of such wider social interests when it introduced the disclosure requirements on social, environmental and ethical issues. In his UKSIF lecture, John Denham said of the £830bn invested in UK pension funds in 1996:

“the investment of such huge sums is bound to have an effect on the wider world. As such the nature of investments made on their behalf shapes the world in which fund members, live, work and retire.”⁶⁶

The challenge of climate change makes these issues all the more relevant. A twenty-five year old pension saver clearly has an interest in not retiring into a world ravaged by irreversible climate change. A recent report concluded that the UK would be hit harder by climate change than many other European countries, largely because of rising sea levels and flooding.⁶⁷ Other potential impacts range from higher food and energy prices to a greater incidence of war and conflict.

Are fiduciary investors able to consider these interests? In a trust context, the law requires first and foremost that fiduciaries must exercise their powers in line with the purposes of the trust. This has been used to argue that since the purpose of a pension fund is to deliver financial benefits, any non-financial considerations are automatically extraneous. But if the purpose of the trust is to provide a pension, what is the purpose of the pension? The obvious answer is ‘to give the beneficiaries a decent standard of living in retirement’. As such, if in the pure pursuit of financial return the trust pursues an investment policy with negative implications for beneficiaries’ future quality of life, this could be said to undermine the ultimate purpose of the trust.

“If the purpose of the trust is to provide a pension, what is the purpose of the pension?”

⁶⁴ UNEP-FI, 2005, op cit. p3 ⁶⁵ Since this relates to beneficiaries’ objective interests rather than their subjective views, such a policy could be based on trustees’ own assessment of beneficiaries’ interests, as distinct from an ethical policy, which, as discussed above, ought to be based on some assessment of the views of beneficiaries themselves. This is not to say that beneficiaries’ should not be involved in determining this and other aspects of their interests, as discussed in Chapter 5. ⁶⁶ John Denham, UKSIF Annual Lecture, July 1998, ‘Building a Better World: The Role of Socially Responsible Pensions’ ⁶⁷ Ciscar et al, 2011, ‘Physical and Economic Consequences of Climate Change in Europe’, Proceedings of the National Academy of Sciences

In a charitable context the courts have explicitly confirmed that the underlying purpose of the trust is a relevant consideration, and that charities are entitled to avoid investments which conflict with their charitable aims (see Box B). Does this imply that pension funds can avoid investment decisions which undermine their aim of giving beneficiaries a secure retirement? It is perhaps surprising that this question has rarely been considered. After all, charities are not the only investors for whom making money is a means to an end rather than an end in itself.

In summary, considering social benefits does not seem to be incompatible with the underlying principles of fiduciary obligation. But what about the specific issues raised in the *Cowan v Scargill* case? These are considered below, using climate change as a case study of how they might apply in practice today.

Social benefits and the duty of impartiality

The first reason the National Union of Mineworkers' (NUM's) proposed investment policy was thrown out was that it breached the duty of impartiality: many of the beneficiaries would not be directly affected by the prosperity of the mining industry, but would be affected by any sacrifice of returns resulting from the proposed policy. There seems no intrinsic reason why this objection should be a particular problem for the consideration of social benefits in general. Indeed, Keith Johnson has argued for reviving the duty of impartiality as a means to promote *greater* focus on long-term ecological sustainability, in particular by considering inter-generational impartiality (see chapter 1).⁶⁸

Different classes of beneficiaries may have different social interests: a 93-year-old pensioner may have no personal interest in averting climate change (although they may well have a concern for the welfare of succeeding generations). But beneficiaries also have differing financial interests. Indeed, if the duty of impartiality prohibited trustees from acting except in cases where all beneficiaries' interests were aligned, they would be paralysed. Where beneficiaries' interests differ, trustees inevitably have to make choices. In such cases the duty of impartiality requires only that they “[hold] the scales impartially between different classes of beneficiaries” (*Cowan v Scargill*).⁶⁹

Nobody suggests that it would be inconsistent with trustees' duty of impartiality to invest prudently over the longer-term simply because they have older beneficiaries who might benefit from a 'slash-and-burn' approach. Arguably, the reverse is true. Similarly, trustees cannot be obliged to create prosperity for one class of beneficiaries by destroying the ecological conditions on which another class depends for its future quality of life. Indeed, that this argument can still be made perhaps reflects the fact that the stringent tests often applied to non-financial issues are disproportionate to those applied when considering financial issues (see Chapter 3). In summary, the duty of impartiality does not seem to create any insurmountable barriers to trustees' consideration of beneficiaries' social and environmental interests.

⁶⁸ Johnson, K. & De Graaf, 'Modernizing Pension Fund Legal Standards for the Twenty-First Century'. *Rotman International Journal of Pension Management* 69 [1984] All ER 750; [1985] Ch270.

“Trustees cannot be obliged to create prosperity for one class of beneficiaries by destroying the ecological conditions on which another class depends for its future quality of life”

‘Too remote and speculative’: can trustees consider macroeconomic issues?

The second objection to the NUM trustees’ proposed policy was that the fund was too small to have an impact on macroeconomic conditions, and the social benefits of the policy were therefore “*too remote and speculative*”. This poses bigger difficulties: it will be impossible for a single scheme to demonstrate that its policy alone is having any material impact on climate change. A fund that integrated carbon footprint targets into its decision-making could therefore in theory be legally exposed if this policy proved financially suboptimal.⁷⁰ This creates a concerning collective action problem: schemes might feel constrained from acting on macroeconomic issues like climate change even if the optimum outcome for all their beneficiaries would be universal collective action which *could* have a material impact on the problem.⁷¹

This should not be an absolute barrier to action by funds. A policy based on engagement rather than exclusion would seem more likely to pass the ‘remoteness test’, both because engagement might enable a single fund or group of funds to have an impact in a way that screening

would not, and because such a policy would be highly unlikely to compromise the fund’s financial performance. Collaborative action with other investors might also be a way forward. Nonetheless, the law as it stands does appear to restrict trustees’ room for manoeuvre in addressing macroeconomic or systemic issues.

This position seems somewhat out of step with current investment practice. Recent years have brought an acute awareness of the significance of systemic risks: issues which no single investor can hope to influence alone, but whose implications if neglected go far beyond the prosperity of a single industry or sector. In the wake of the banking collapse, few would suggest that these systemic risks cannot be a legitimate consideration for individual market participants. Just as fiduciary obligation has evolved in the past to take account of developments such as modern portfolio theory, perhaps it now needs to be updated to reflect the latest thinking on systemic risk (see Chapter 1).

“Just as fiduciary obligation has evolved in the past to take account of developments such as modern portfolio theory, perhaps it now needs to be updated to reflect the latest thinking on systemic risk”

⁷⁰ Scantlan C., 2010, *op cit.* p22 ⁷¹ *Ibid* p23

Universal owners and climate change

The example of investor initiatives on climate change raises another question: is a business-case approach (see Chapter 3) sufficient to justify a proactive climate policy without delving into the vexed issue of non-financial interests? ‘Universal owner’ theory⁷² suggests that funds with holdings across the economy have an interest in the stability and prosperity of the economy as a whole, including its environmental sustainability. It is therefore in their financial interests to avoid externalities which may make one company in their portfolio (in this example, say an oil major) enormously profitable, but for which the tab will be picked up elsewhere in the economy to the detriment of their portfolio as a whole. As one participant at our seminar put it, *“the reason you don’t want to make these investments is it turns the world to dust, and what will happen if the world turns to dust? Lots of the assets you have will lose massive amounts of value.”*

Arguably the problem with the present situation is fairly well summed up by the fact that trustees are forced to defend their beneficiaries’ interest in their not ‘turning the world to dust’ purely on the basis that it would cause their assets to lose value. This mirrors the stark passage of UNEP’s 2009 report which notes that funds taking a business-case approach could not avoid investing in cluster bombs based on their involvement in *“the indiscriminate killing of innocent civilians and children”*, but may be able to justify excluding them on the basis that *“a company making cluster bombs may not have a long term future.”*⁷³

“ *Business-case arguments may take funds a long way, but it would be naïve to assume - even for universal investors - that they will always coincide with the socially, environmentally or ethically desirable course of action* ”

As Professor Benjamin Richardson has argued, the problem with business-case RI is that sometimes there may not be a business case. He cites the case of Ford Pinto in the 1970s, when it was concluded that recalling cars with a defective fuel system would be more costly than expected litigation due to deaths or injuries.⁷⁴ Business-case arguments may take funds a long way, but it would be naïve to assume - even for universal investors - that they will always coincide with the socially, environmentally or ethically desirable course of action. Relying on business-case arguments may not fully resolve the underlying issue of a perceived legal position that constrains fiduciaries’ ability to act on their beneficiaries’ non-financial interests.

Universal ownership in practice: a tragedy of the commons?

In addition, even within the business-case approach there is still a need to overcome the collective action problem created by the ‘remoteness’ of systemic issues. Practical experience suggests that

⁷² Hawley & Williams, 2000, *The rise of fiduciary capitalism: How institutional investors can make corporate America more democratic*, University of Pennsylvania Press ⁷³ UNEP-FI, 2009, *op cit*, p27 ⁷⁴ Richardson, BJ. ‘*Keeping Ethical Investment Ethical: Regulatory Issues for Investing for Sustainability*’, *Journal Of Business Ethics* (2009) 87: 563

business-case action on climate change is being held back by precisely this factor. In 2009, 89% of fund managers surveyed by FairPensions rated climate change as an ‘important’ or ‘very important’ investment issue - yet only 29% factored climate data into their analyses for all companies where it was available.⁷⁵ It might be difficult to use universal owner arguments to justify a climate-based stock-picking policy, since disinvestment from an environmentally damaging company by a single fund will not, by itself, protect that the rest of that fund’s portfolio from the negative externalities the company creates. Universal owner theory therefore seems to lend itself best to an engagement-based approach.

Even in an engagement context, where robust universal owner arguments can be made in theory, they do not always appear to gain traction in practice. For example, when discussing shareholder resolutions about oil sands in 2010, many investors were unwilling to engage with ‘universal owner’ arguments emphasising the potential impacts of marginal oil extraction on their portfolio as a whole, insisting that a business case needed to be made based on the projects’ specific implications for BP’s profitability. Yet when BP cancelled its dividend due to an environmental disaster months later, investors played down concerns by rightly insisting that they should be judged on the performance of their portfolio as a whole, of which BP made up only a small part.

One explanation for this reluctance to engage with ‘universal owner’ arguments is the disconnect between abstract recognition of the material impacts of climate change and the ‘nuts and bolts’:

i.e. its practical application to investment decisions about individual issues. Even funds which treated climate change as a serious investment issue made clear in relation to the oil sands resolutions that ‘stopping climate change’ could not be their concern - they required a business case to be made on the merits of the narrower issue in question.⁷⁶ Whilst recognising climate change as a risk, most investors apparently do not feel able to justify decisions solely on the basis that they help address this risk, since they are too small to make a difference acting alone.

Some investors have tried to overcome this through collaborative initiatives, such as the Institutional Investors Group on Climate Change (IIGCC) - whose members aim to “*use their significant collective influence to engage in dialogues with policymakers, investors and companies to accelerate the shift to a low carbon economy.*”⁷⁷ The UNPRI, another collaborative initiative, explicitly cites the systemic nature of climate risk as a reason for universal owners to act.⁷⁸ But even the members of these forums may still feel they have limited room for manoeuvre when it comes to their individual buy/sell or voting decisions. Prominent sustainable investors, such as the Environment Agency Pension Fund and London Pension Fund Authority, tend to emphasise actions which can be justified at the level of individual firm profitability as adapting to government action on climate change - such as higher carbon prices or more stringent environmental regulation. In practice this is different from justifying a decision on the general basis that it helps mitigate climate change, despite the language used by the UNPRI and IIGCC.

⁷⁵ FairPensions, 2009, ‘*Preparing for the Storm? UK fund managers and the risks and opportunities of climate change*’

⁷⁶ Based on anecdotal evidence from our third seminar ⁷⁷ <http://www.iigcc.org/about-us>, accessed on 10/02/11

⁷⁸ UNPRI, 2009, ‘*Investor leadership on climate change: An analysis of the investment community’s role on climate change, and a snapshot of recent investor activity.*’

Given that universal owner arguments are predicated on investors' interest in the health of the wider economy, this creates the potential for a 'tragedy of the commons' with implications far beyond climate change. Universal owner arguments have significant potential, but the collective action problem highlighted in *Cowan v Scargill* may need to be addressed if this potential is to be realised. As Charles Scanlan's paper concluded, "*there may be a need for legislation to authorise fiduciaries to act as 'good citizens' even for them to promote their own beneficiaries' best interests, let alone the public interest.*"⁷⁹ This could be achieved through permissive rather than prescriptive provisions, an example of which we set out in Chapter 6

“ *There may be a need for legislation to authorise fiduciaries to act as ‘good citizens’ even for them to promote their own beneficiaries’ best interests, let alone the public interest* ”

⁷⁹ Charles Scanlan 2010, p23

There are therefore sound reasons to think that a prudent policy which takes into account beneficiaries' ethical views could be legally justified. But the legal position remains unclear, and without statutory clarification, it is unlikely that it will ever be conclusively resolved or that trustees will feel free to exercise their judgement on such matters.

Less consideration has been given to beneficiaries' other non-financial interests - for instance, social and environmental issues such as climate change that will affect beneficiaries' quality of life regardless of the impact on financial return. The key issue that arises here, both legally and practically, is the 'remoteness problem': individual investors may be too small to have a material impact on a given macroeconomic issue, and may therefore find it difficult to justify attempting to do so. This creates a serious collective action problem if, as with climate change, the optimal outcome for all beneficiaries would be universal action which *could* have an impact on the problem. Further thought needs to be given to how this problem can be overcome, whether through investor collaboration, legal changes, or some combination of the two.

Summary of Recommendations

- **DC schemes** should offer an ethical option based on an assessment of members' ethical preferences
- **Pension funds**, when asked by members to consider an ethical issue, should perform an analysis of its effect on their portfolio, in line with the 'ethical tie break' principle. Currently many funds wrongly invoke fiduciary duty to justify a refusal even to consider a non-financial issue.
- **Statutory clarification** is needed on the extent to which ethical and social considerations can be taken into account, in order to end current confusion and disagreement as well as over-reliance on often questionable interpretations of a small number of legal decisions with doubtful relevance to contemporary circumstances. Chapter 6 provides a possible template.

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Chapter

The Members' Contribution

Transparency, accountability
and involvement

“ I feel there is occasionally a need to remind those who manage our money that it is our money. ”

Steve Webb, Pensions Minister, 14 December 2010

Fiduciaries are required to act in beneficiaries' best interests, but it is generally assumed that it is for the fiduciaries to determine what those interests are. For instance, beneficiaries who express concern about ethical issues often encounter the seeming paradox of being told that their wishes cannot be taken into account because of the trustees' fiduciary duty to act in their best interests. This chapter asks whether there is scope for beneficiaries to contribute their own views about their interests, and to play a more active part in decisions about their money.

The beneficiary's role - a culture of passivity

The idea that members should have a role in determining their own best interests does not have widespread acceptance. For instance, it appears that pension funds rarely consult their members about issues such as the availability and content of ethical fund choices. In a 2006 study, 53% of UK pension fund trustees said they attached 'no significance' to their members' views when considering their policy on environmental, social and governance (ESG) issues.¹ Pension fund members who proactively contact their funds about such issues often encounter what Labour MP Jon Cruddas described in a recent parliamentary debate as "a culture of hostility to the people whose money is at stake having the impertinence to ask questions."² One commentary on the post-Myners pension reforms opined that "the dilemma for trustees is that they are still vested with the assets and have legal responsibility for their prudent investment, but choices are being made by third parties, the members."³ The idea that pension savers are 'third parties' to decisions about their own money is

typical of attitudes in this area - and seems particularly illogical given that it is the members whom trustees' legal responsibility exists to protect.

To some extent, this culture reflects the origins of the trust-based fiduciary relationship. As was observed in our third seminar, "you don't get that [hostility] when you ring a high street pension provider because they have the notion that you're a customer." In contrast, the status of beneficiaries of a trust has traditionally been passive - although, as we will see, it has always been the case that beneficiaries have a right to be kept informed about the administration of a trust. This passivity is well encapsulated by a comment of the Ontario Law Reform Commission in 1984 that

"to allow beneficiaries to direct the ongoing administration of the trust confuses the role of trustee and beneficiary and is inconsistent with the trust concept."⁴

It could be argued that the passive status of beneficiaries is part and parcel of the high standard of care expected of fiduciaries: as we saw in chapter 1, fiduciary obligations are so strict precisely because they involve a relationship of dependency. Yet this need not be inconsistent with members having a greater voice. Members may be competent to contribute in certain areas of decision-making - such as on engagement strategies, ethical matters or risk appetite - but in other areas, such as asset allocation, they remain highly dependent on trustees' and fund managers' expertise to ensure the prudent management of their money. As such, there seems no reason to assume that member involvement in itself undermines the basis of the fiduciary relationship.

¹ Gribben, C. and M. Gitsham, 2006, 'Will UK Pension Funds Become More Responsible: A survey of trustees', UK Social Investment Forum, p14. ² HOC Debate 14 Dec 2010: Col 883 ³ Richards, 2002, 'The Evolving Role of the Pension Fund Trustee', Pensions 8(1) ⁴ Ontario Law Reform Commission, 1984, 'Report on the Law of Trusts', Ministry of the Attorney General, p74. Cited in Richardson, B.J. 'From Fiduciary Duties to Fiduciary Relationships: Responding to the Will of Beneficiaries,' Journal of Sustainable Finance and Investment (2011) 1: 1-15 ⁵ Section 11, Trusts of Land and Appointment of Trustees Act 1996

Indeed, there are already examples under English law of trustees being required to consult beneficiaries. For instance, trustees of land must consult the beneficiaries so far as practicable on any decisions relating to the land, and their wishes must be complied with so far as consistent with the interests of the trust.⁵ In this way, the requirement to consult does not compromise the decision-making role of the trustee. In a pensions context, employers or trustees with the power to amend schemes are required to consult with beneficiaries before making amendments on certain prescribed matters. Regulations also detail how such consultations are to be conducted.⁶

Certainly, trustees should not act blindly on beneficiaries' instructions, just as they should not act blindly on anyone's instructions. But a requirement to consult beneficiaries and consider their views - as has been suggested by Professor Benjamin Richardson - would not undermine the principle that trustees are solely responsible for their decisions, as many seem to think it would. Trustees would retain the discretion to decide on the most practicable and cost-effective method of satisfying themselves that the policy fairly reflected the beneficiaries' views. They would also retain the discretion as to the final form of the policy.⁷

In his paper for our third seminar, Charles Scanlan suggested a case for pension fund beneficiaries having a particular claim to participation and consultation, since, unlike most beneficiaries of the original family trusts, they themselves provide the capital to be invested.⁸ This argument is only strengthened by the shift to defined contribution (DC) pension arrangements, where beneficiaries not only provide

the capital but also bear the investment risk. (Of course, DB members' position is not entirely risk free either, since they run the risk of employer insolvency or scheme closure if the scheme's liabilities cannot be met.) In 2009, there were 2.2 million active members of defined benefit (DB) schemes, compared to 4.1 million in workplace DC schemes (both trust and contract based). The number of people in DC schemes is predicted to increase by at least 5 million as a result of the government's auto-enrolment reforms.⁹ When individual personal pension arrangements are taken into account, the proportion of all savers covered by DB pension schemes falls even further.

Furthermore, as Professor Benjamin Richardson has noted, "*More voice to beneficiaries is particularly important when beneficiaries have limited ability to transfer their savings elsewhere.*"¹⁰ In today's investment landscape, it seems hard to maintain the argument that there are no grounds for beneficiaries to participate in decisions about the management of their money. Indeed, there are sound reasons to agree with Richardson's suggestion that pension funds should have explicit responsibilities to actively inform and consult.¹¹

“ In today's investment landscape, it seems hard to maintain the argument that there are no grounds for beneficiaries to participate in decisions about the management of their money ”

⁶ The Occupational and Personal Pension Schemes (Consultation by Employers and Miscellaneous Amendment) Regulations 2006, SI 2006/349 ⁷ Scanlan C., 2010, '*Best Interests Redefined : Background Paper*', available online at http://www.fairpensions.org.uk/sites/default/files/uploaded_files/CharlesScanlanBestInterestsLong.pdf. p19

⁸ Ibid, p24 ⁹ The Pensions Regulator, 2011, '*Enabling good member outcomes in work-based pension provision*', p12.

¹⁰ Richardson 2011, *op cit*: p23 ¹¹ Ibid

Recommendation: Pension funds should consult with their members and should encourage and welcome member engagement, including by providing full and open disclosures on their investment policies and practices

Recommendation: TPR should seek to facilitate and support funds to engage with their members, for instance through the dissemination of model surveys or best practice guidance.

Transparency - a right to know?

At the very least, the shift to DC creates an even stronger case for greater transparency to give beneficiaries visibility on the decisions which will determine their future retirement income. Indeed, transparency is also a prerequisite to participation. At present, a culture of opacity which parallels the culture of passivity acts as a significant barrier to meaningful engagement by beneficiaries.

In one particular - and important - respect, this culture of opacity can to some extent be traced to the legal assumptions surrounding the fiduciary relationship. Trustees do not have to disclose to their beneficiaries the reasons why they decided to exercise a discretionary power in a particular way (and therefore will not normally be required to disclose documents to beneficiaries that reveal such reasons).¹² This principle evolved in the context of private trusts, where its main rationale was that for trustees to disclose their

“Less than a quarter of funds disclose information to members about their exercise of shareholder voting rights, and almost half do not even disclose their voting policy”

reasons might give rise to embarrassment and family discord. Yet it has been applied to pension schemes, in circumstances in which such considerations have little or no relevance.¹³ Legal commentators have described this presumption as presenting “an insurmountable obstacle to effective scrutiny of the trustees’ decision-making” and have suggested that the principle could be abandoned either in relation to all trusts or at least in relation to quasi-public trusts such as pension schemes.¹⁴ Indeed, in a recent English case the question was left open as to whether the principle should still apply outside the family trust sphere.¹⁵

In practice, when it comes to investment decisions and the exercise of ownership rights, most beneficiaries are far from being actively informed of their fund’s activities. According to the most recent figures from the National Association of Pension Funds, less than a quarter of funds disclose information to members about their exercise of shareholder voting rights, and almost half do not even disclose their voting policy.¹⁶ Moreover, many fund members have difficulty accessing such information even when they specifically request it. Many individuals who enquired how their fund intended to vote on 2010’s shareholder resolutions about oil sands

¹² *Re Londonderry’s Settlement*, Court of Appeal, 1964 3 All ER 855 ¹³ *Edge v Pensions Ombudsman* [1998] Ch512, *Wilson v Law Debenture Trust Corporation* [1995] 2 All ER 337 ¹⁴ Pearce, Stevens & Barr, 2010, ‘*The Law of Trusts and Equitable Obligations*’, 5 ed., Oxford: OUP. p841 ¹⁵ *Breakspear v Ackland* [2009] Ch 32, cited in Pearce, Stevens & Barr, 2010, p841. ¹⁶ NAPF, May 2010, ‘*Pension Funds’ Engagement with Companies*’, p21 ¹⁷ Based on discussion at our third seminar: FairPensions, July 2010, ‘Best interests redefined’. ¹⁸ Occupational Pension Schemes (Disclosure of Information) Regulations 1996, SI 1996/1655, Regulation 7

were either told that the fund did not know, directed to a generic policy in the scheme’s Statement of Investment Principles or given no response at all.¹⁷

UK law currently requires occupational pension schemes to disclose some information to members on request, including the Statement of Investment Principles (SIP).¹⁸ But there is no statutory requirement to disclose how this policy has been implemented, either on a regular basis (for instance, through the Annual Report) or in response to specific member requests. Schemes must disclose any investments made during the year which were in *contravention* of the SIP,¹⁹ but this does not appear to extend to information on voting decisions – still less to an account of how the scheme exercised its investment powers and ownership rights in *accordance* with the SIP. There is a strong case for extending these disclosure requirements through either hard or soft regulation, to enhance members’ right to information.

In addition, current disclosure requirements are not consistent across different types of pension provision. For instance, the requirements in relation to voting policy and to social, environmental and ethical considerations do not apply to wholly-insured schemes (or to personal pension providers). Any review of the disclosure regime would need to consider how to achieve consistency, particularly between trust-based and contract-based pension arrangements.

Consensus and the duty of impartiality

What degree of consensus is required among beneficiaries before their views can be taken into account? The key fiduciary

duty in this context is that of impartiality. Is it a breach of the duty of impartiality to give effect to the views of some beneficiaries if those views may not be shared by all beneficiaries? This problem does not arise in every case. For instance, DC schemes offering an ethical fund choice based on a majority view would not engage the duty of impartiality even if that fund offered lower returns, since the minority would not be obliged to choose it: *“if beneficiary A chooses a highly restrictive fund, that doesn’t prejudice beneficiary B, who’s gone for a different fund.”*²⁰ Of course, there is also the separate question of how trustees decide what fund choices to offer – for instance, any consultation process ought to give all beneficiaries an equal opportunity to express their views. Similarly, taking account of beneficiaries’ views in decisions *within* their chosen funds may raise questions about the duty of impartiality.

Some jurisdictions have taken a pragmatic approach to the question of consensus – such as Ontario, Canada, which passed legislation allowing divestment from apartheid South Africa, even if returns were adversely affected, as long as the majority of beneficiaries had consented.²¹ UK law is extremely unclear on this question. Some hints can be gleaned from the limited case law on consideration of members’ ethical preferences. Yet, as the Freshfields report noted, *“little guidance is available from the case law as to whether unanimity is required or the precision with which beneficiaries’ interests must be identified.”*²² The judge in *Cowan v Scargill* suggested that, in a trust where the beneficiaries were adults who all shared strict views on moral and social matters, these views could be accommodated

¹⁹ Occupational Pension Schemes (Disclosure of Information) Regulations 1996, SI 1996/1655, Schedule 3(14) ²⁰ Comment by participant at our third seminar: FairPensions, July 2010, ‘Best interests redefined’ ²¹ South African Trust Investments Act, 1988 ²² UNEP-FI, 2005, ‘A legal framework for the integration of environmental, social and governance issues into institutional investment’, p96 ²³ Because there will always be contingent beneficiaries who are unascertained and/or minors who cannot give a valid consent. See Scanlan, C. 2010, ‘Best Interests Redefined: Background Paper’, available online at http://www.fairpensions.org.uk/sites/default/files/uploaded_files/CharlesScanlanBestInterestsLong.pdf. p11

even if it was financially detrimental to the fund (see Chapter 4). Such a degree of consensus is impossible in a pensions context.²³ Where no financial sacrifice is involved, an absence of consensus should not in practice pose a problem for the duty of impartiality. Since those who might disagree with the policy would not be suffering financially, their interests would only be compromised if they held equally strong but opposing moral views. As Charles Scanlan puts it, *“How likely is it that there will be beneficiaries whose ethical belief systems lead them actively to support child labour?”*²⁴

In his subsequent paper about the case, the judge in *Cowan v Scargill* endorsed this argument: an investment made on ethical grounds which does not carry a financial penalty *“will in general be for the benefit of the beneficiaries at large”*, since, *“gratifying the majority, [it] will neither harm nor benefit the minority”*.²⁵ As Charles Scanlan has observed, this logic seems to apply equally whether or not those beneficiaries who are ‘gratified’ by the decision are in fact in the majority. Therefore,

*“On the assumption that the scheme suffers no financial harm... there is no trust law requirement to obtain the views of all beneficiaries. If the trustees can confer a non-financial benefit on a significant number of their beneficiaries, that should be sufficient justification.”*²⁶

In other words, it would appear that if any beneficiary or beneficiaries expresses a view to their trustees, this view can be accommodated as long as it does not jeopardise the interests of other beneficiaries. Yet the legal position remains somewhat uncertain, and positive legal requirements for beneficiary

“It would appear that if any beneficiary or beneficiaries expresses a view to their trustees, this view can be accommodated as long as it does not jeopardise the interests of other beneficiaries”

consultation are limited. As Benjamin Richardson has argued, legal clarification may be needed if beneficiaries are to take more of a role in decisions about their investments.²⁷

In practical terms, procedures could be designed to overcome problems of impartiality in cases where members might hold conflicting views. For instance, Charles Scanlan gives the example of a standing procedure under which the beneficiaries could be given the opportunity to take part in a deliberative process followed by an advisory vote on whether a disputed ethical preference should be adopted as part of the scheme’s investment policy. The trustees would be required to take the result of the vote into account, although without being bound by it. Such a procedure could be said to confer an equal benefit on all the beneficiaries - by giving them an equal opportunity to make their views known and to shape scheme policy - which would satisfy the duty of impartiality notwithstanding the disadvantage to individual beneficiaries from being in the minority on a particular occasion.

²⁴ Scanlan C., 2010, *op cit*, p18 ²⁵ Sir Robert Megarry, ‘Investing Pension Funds: The Mineworkers Case,’ in Youden, T.G. (ed), 1989, *‘Equity, Fiduciaries and Trusts’*, Toronto: Carswell ²⁶ Scanlan, C. 2005, *‘Socially Responsible Investment: A Guide for Pension Schemes and Charities’*, Key Haven, p98 (endorsed in UNEP-FI, 2005, *‘A legal framework for the integration of environmental, social and governance issues into institutional investment’*, p97)

²⁷ Richardson 2011, *op cit*

Recommendation: *DWP should ensure that any new guidance for trustees clarifies the relationship between member involvement and the duty of impartiality, and should consider statutory clarification of this point if necessary.*

Practical barriers to member involvement

If trustees are not required to canvass the views of *all* beneficiaries before they can take account of the preferences of a particular sub-group, the practical difficulties of member involvement are considerably reduced. Even where a particular decision requires members as a whole to be consulted, this could be a less onerous task than many might suppose. For instance, the existing requirements for consultation on certain pension scheme amendments allow decision-makers to consult with elected representatives of affected members, such as trade union representatives. Only if there are affected members without elected representatives do the decision-makers need to consult with the individual members directly.²⁸

Of course, there may be some cases where it is desirable for trustees to survey the views of their membership as a whole, or at least of a representative sample - which, in a scheme with hundreds or thousands of members, could be a logistical challenge. However, there seems no reason to suppose that this is an insurmountable barrier. Consultation could relate to the drawing up of a general policy, rather than continuous engagement with decisions on a case-by-case basis.²⁹

The Pensions Trust is one scheme which has undertaken a survey, based on a representative sample of scheme members, to determine which ethical issues matter most to its membership. The difficulty and cost of conducting such surveys has been greatly reduced by the advent of the internet, including free online survey services.

Another approach is that taken by NEST - whose membership does not yet formally exist, and who therefore made use of research about the attitudes and preferences of its target demographic.³⁰ This suggests an opportunity for schemes who do not have the resources to undertake their own research to use the results of existing research into groups with similar characteristics to their members. Although unlikely to be a perfect reflection of their members' preferences, this would be an advance on the present situation, where fund options - including ethical fund options with highly restrictive screens - often appear to be chosen without any recourse at all to what members may or may not value.

Large schemes with a dispersed membership and/or with greater resources at their disposal could also follow the example of CalPERS (The California Public Employees Retirement System) which holds two board meetings a year off-site to encourage participation by members. These meetings are attended on average by over 100 people. CalPERS' commitment to transparency may hold lessons for smaller schemes too: as a rule its board meetings are held in public, with board minutes and papers posted on the internet along with policies and voting decisions.³¹

²⁸ The Occupational and Personal Pension Schemes (Consultation by Employers and Miscellaneous Amendment) Regulations 2006, SI 2006/349, Regulations 12 & 13 ²⁹ Dr Bernadette Kamleitner, 2010, 'Survey Report - Members' Views on Responsible Investment', unpublished (cited with permission from The Pensions Trust). The survey template is available on request from The Pensions Trust for other schemes wishing to conduct a similar exercise. ³⁰ PADA, May 2009, 'Building personal accounts: designing an investment approach', p117-122. See also DWP, 2007, 'Research Report #550: Individuals' attitudes and likely reactions to the workplace pension reforms 2007: Report of a quantitative survey'. ³¹ Anne Simpson, 2010, FairPensions Annual Guest Lecture : 'In the wake of the financial crisis : Rethinking Responsible Investment'. Available at http://www.fairpensions.org.uk/sites/default/files/uploaded_files/Annesimpsonpdf.pdf

Aside from the purely logistical difficulties with canvassing members' views, one oft-cited objection to the idea of consulting members is their lack of expertise or interest in investment issues. Given that we have had to introduce auto-enrolment just to get people saving into a pension in the first place, the argument goes, can we realistically expect them to take an active interest in their scheme's investment governance or ethical policy? This argument has been invoked to justify the small but increasing minority of employers who offer members no choice at all, providing only a default option. Intermediaries interviewed anonymously in research for the DWP suggested that giving members choice was pointless, since they would only be confused and unable to make appropriate choices.³² Yet the solution to this problem must lie in striving to better equip members to make informed decisions, rather than simply dismissing the prospect of their taking any control over their savings at all.

Indeed, research suggests that one of the reasons many people are reluctant to save into a pension is lack of trust: in the wake of high-profile scandals such as Maxwell and Equitable Life, people feel that saving into a pension is risky or that their money is not safe.³³ Anecdotally, some industry participants suggest that where employers make an effort to engage with members about scheme governance, this can actually boost take-up of occupational pension provision. In addition, surveys suggest that members value clear communication and information from schemes:³⁴ improved transparency is an important part of restoring trust and thereby encouraging pension saving. Member involvement may therefore be part of the solution to widespread

disinterest in pension saving, rather than a problem as is often assumed.

“Improved transparency is an important part of restoring trust and thereby encouraging pension saving”

Moreover, the practical experience of grassroots campaigns, from the anti-apartheid movement in the 1980s to the 2010 campaign around shareholder resolutions on oil sands, demonstrates that many people take a particular interest in the social consequences of their investments, whether it be through the stocks held or the exercise of shareholder rights. Indeed, ethical questions have one huge advantage over other aspects of investment when it comes to engaging beneficiaries: they do not require any expert technical knowledge. People may be put off by the complex language and concepts surrounding pensions; likewise, they may not be competent to engage with complex decisions about asset allocation. But many will have an opinion about the arms trade or environmental destruction, and the desire to voice that opinion and see it reflected in the investment decisions made on their behalf. Indeed, if the experience of recent campaigns is anything to go by, the difficulty lies not in beneficiaries' ability to express a view, but in the ability or willingness of pension funds to engage with that view. Perhaps, as Pensions Minister Steve Webb MP has observed, *“there is occasionally a need to remind those who manage our money that it is our money.”*³⁵

³² DWP, 2011, ‘Research report #725: The use of vesting rules and default options in occupational pension schemes’, p25 ³³ See for example Taylor-Gooby, P., 2004, ‘Trust and the Governance of Risk: Responses to the New Pension Settlement’, School of Social Policy, Sociology and Social Research, University of Kent ³⁴ Dr Bernadette Kamleitner, 2010, ‘Survey Report - Members' Views on Responsible Investment’, unpublished (cited with permission from The Pensions Trust), p5 ³⁵ HOC Debate 14 Dec 2010: Col 889

Implications for insurance companies

The case for greater member involvement would seem to apply with equal force to contract-based arrangements. A recent paper by the OECD concluded that

“Where members take on risk, provisions should be made for their input into appointments and other decisions (either via representation on the governing body or at least via an approval process at the AGM).”³⁶

As such, any legislative change to grant more participatory rights to beneficiaries should extend to all financial institutions managing pension investments.³⁷

Anecdotally it appears that high street pension providers can be more open to queries from their customers than many trust-based schemes are to their members. On the other hand, the accountability gap for individual retail customers is potentially greater than that in trust-based schemes: the absence of a board of trustees featuring member representation means that there is no obvious link between the preferences of customers and the decision-making structure. This could be partially dealt with by the suggestion of a ‘policyholders’ committee’ set out in Chapter 2.

In addition, the customer base of these providers is likely to be much more dispersed than the average occupational pension scheme’s, and less likely to have shared characteristics (for instance, because the scheme is open to members of a particular company or profession). This may make it more difficult both to consult customers directly and to take proxies for their views or preferences based on existing research into particular demographic groups. It might be countered

“The accountability gap for individual retail customers is potentially greater than that in trust-based schemes”

“There is no obvious link between the preferences of customers and the decision-making structure”

that this is not necessary, since individual customers are able to choose from a wide variety of products and firms are required to ensure that the products recommended are suitable for the individual’s particular needs and risk profile.³⁸ But this does not guarantee either meaningful customer input into, for instance, the ethical policies of the funds made available, or ongoing accountability and visibility for investment decisions and governance.

It might also be argued that, unlike members of workplace pension schemes, customers of retail pension providers generally have a higher degree of consumer choice between different providers and are therefore able to ‘vote with their feet’. Yet, in the absence of transparent and relevant information, it is difficult for them to exercise this ability in a well-informed way. This adds to the case for greater public disclosure on the part of these providers on issues ranging from costs and fees to the exercise of shareholder

³⁶ Stewart, F. and J. Yermo (2008), “Pension Fund Governance: Challenges and Potential Solutions”, OECD Working Papers on Insurance and Private Pensions, No. 18, OECD publishing ³⁷ Scanlan C., 2010, *op cit.* p26 ³⁸ See FSA Principles for Businesses, Principle 9

rights (see Chapter 6). Such data can be used by consumer organisations to present individual consumers with meaningful comparative information on which to base their decisions. Given the complex and opaque nature of pension provision, this is an essential part of ensuring an effective and open market.

Large insurance firms are not faced with the same problems of resources and governance capacity which might be experienced by smaller workplace pension schemes, and may therefore be in a better position to actively reach out to their customer base. The example of ‘roadshows’ as organised by CalPERS (discussed above) may be an appropriate model for such activity. Such face-to-face outreach would provide the opportunity for a two-way information exchange: both seeking members’ input in areas where their preferences may be taken into account, and giving members an opportunity to ask questions and hold accountable those who are managing their money.

Recommendation: *Insurance companies should devote more attention to outreach, communication and accountability to policyholders, for instance by organising roadshows.*

Chapter Summary

The role of beneficiaries in the fiduciary relationship has traditionally been passive, but more recently there has been a trend towards the granting of more rights to information to pension savers and legal recognition of their legitimate interest in the governance of their scheme. The case for greater member consultation and transparency is enhanced by the shift towards defined contribution (DC) pension arrangements in which members bear the investment risk. Research also suggests that people value communication and consultation, and that such engagement may help overcome the distrust that puts many off from saving into a pension at all.

The legal position, however, remains somewhat confused, and a paternalistic attitude to trust-based provision, hostile to member involvement, persists in many quarters. Pension providers - both trust- and contract-based - should be encouraged to consult and inform their members. As part of this effort, some legal changes may be needed, both to clarify the extent to which members’ views may be taken into account by trustees, and to guarantee members an adequate level of disclosure and consultation.

Summary of Recommendations

- **Pension funds** should consult with their members and should encourage and welcome member engagement, including by providing full and open disclosures on their investment policies and practices
- **TPR** should seek to facilitate and support funds to engage with their members, for instance through the dissemination of model surveys or best practice guidance.
- **DWP** should ensure that any new guidance for trustees clarifies the relationship between member involvement and the duty of impartiality, and should consider statutory clarification of this point if necessary.
- **Insurance companies** should devote more attention to outreach, communication and accountability to policyholders, for instance by organising roadshows.

The image features a dark purple background. In the top-left corner, there are two horizontal bars: a light purple one on top and a white one below it. A large, stylized number '6' is positioned on the right side, rendered in a light purple color with a dark purple shadow. The word 'Chapter' is written in a white, italicized serif font on the left side.

Chapter

The Enlightened Fiduciary

Lessons from the Companies Act
for institutional investors

“ *Directors must promote the success of the company for the benefit of its shareholders, and this can only be achieved by taking due account of both the long-term and short-term, and wider factors such as employees, effects on the environment, suppliers and customers* ”

Company Law Reform White Paper, 2005

Collectively, pension funds are now enormous and important actors in the global economy, a far cry from the family trusts of the eighteenth century for whom fiduciary obligations were developed. The days when the typical fiduciary was a family friend or executor of a will holding a modest portfolio of assets have long gone. The fiduciaries of today include giant institutions whose decisions have a very real impact on the economy, on society and on the environment. In 1963, individuals made up more than half of UK share-ownership;¹ by 2008, this had decreased to around 10%, while pension funds and insurance companies accounted for a combined 26.2%.²

At the end of 2009, the total assets of pension funds, insurance companies and trusts were valued at £2669 billion.³ As former Pensions Minister John Denham observed, “*the investment of such huge sums is bound to have an effect on the wider world.*”⁴ Some of these consequences - such as the potential of fiduciary investments to enhance or impede efforts to tackle climate change - have been considered in previous chapters, but always through the prism of the interests of the beneficiaries, the pension savers. This chapter poses a more fundamental question: does the status of pension providers as major economic actors undermine the basic principle that their obligations are owed exclusively to these beneficiaries?

The public interest argument

The financial crisis was a stark lesson in the potential impacts of institutional

investor behaviour, not just on underlying asset owners, but on all market participants. In the aftermath of the crisis, there was widespread recognition that institutional investors had not done enough to curb excessive risk-taking and poor corporate governance in the financial institutions they owned.⁵ In the UK, this culminated in the Stewardship Code,⁶ an initiative to encourage responsible share-ownership which is now being replicated internationally from the Netherlands⁷ to South Africa,⁸ with the European Commission also considering a single Europe-wide Code.⁹ Interestingly, many of these jurisdictions appear to be placing emphasis on stakeholder interests and/or environmental and social responsibility, something the UK authorities have been reluctant to do.

“Pension funds are now enormous and important actors in the global economy, a far cry from the family trusts of the eighteenth century for whom fiduciary obligations were developed”

But it is not just investors' ownership activities which may have wider ramifications. Pension funds were not exempt from other investor behaviours that came under scrutiny after the crash, whether it be enthusiasm for exotic

¹ BIS, 2010, 'A long-term focus for corporate Britain', p17 ² Office for National Statistics, 'Share ownership', <http://www.statistics.gov.uk/cci/nugget.asp?id=107> (accessed on 10/03/11) ³ Office for National Statistics, 'Investment by insurance companies, pension funds and trust 3rd quarter 2010' ⁴ UKSIF Annual Lecture, July 1998, 'Building a Better World: The Role of Socially Responsible Pensions' ⁵ Sir David Walker, 2009, 'A Review of Corporate Governance in UK banks and other financial industry entities' ⁶ Financial Reporting Council, 2010, 'The UK Stewardship Code', available online at www.frc.org.uk ⁷ Responsible Investor, October 5 2010, 'UNPRI needs to raise its game says Robeco CEO Munsters'. ⁸ http://www.iodsa.co.za/downloads/documents/CRISACode31Aug12010_For_Public_Comment.pdf (accessed on 10/03/11) ⁹ European Commission, June 2010, Green Paper 'Corporate governance in financial institutions and remuneration policies', COM(2010) 284 Final ¹⁰ Woolley, P. 'Why are financial markets so inefficient and exploitative - and a suggested remedy', in LSE, 2010, 'The future of finance': p133

derivatives or the extraordinary growth in churn across the equity market, which now stands at 150% per year of aggregate market capitalisation.¹⁰ Indeed, as we saw in Chapter 1, the tendency among investors to herd, and the systemic risks this tendency can pose, may actually be *exacerbated* for fiduciary investors by prevailing interpretations of their legal duties, particularly the duty of prudence.

This chapter will consider two different ways in which fiduciary obligation might be reshaped in response to these wider interests. The first alternative would be a full ‘*stakeholder*’ model: fiduciaries might owe duties directly to non-beneficiaries, or such third parties might have a right to participate in decisions. The second alternative would be an ‘*enlightened fiduciary*’ model, similar to that governing company directors under UK law: fiduciaries would still be required to act in the interests of their beneficiaries but, in doing so, to have regard to the long-term and societal consequences of their decisions. Independent of such debates, the public interest in fiduciary investors’ behaviour creates a compelling case for greater transparency and public disclosure. This chapter will also consider ways in which this might be achieved.

“*The financial crisis was a stark lesson in the potential impacts of institutional investor behaviour, not just on underlying asset owners, but on all market participants*”

The stakeholder model: companies versus pensions

Stakeholder theory has been debated extensively in a company context, both in the academic literature and in the public sphere (for instance, as part of the UK Company Law Review).¹¹ The differences between the UK’s corporate governance framework, which remains firmly focussed on shareholders, and the more or less pluralist systems of countries such as Germany and the Netherlands, are well rehearsed. This chapter is not directly concerned with the merits of the stakeholder approach for companies; however, it considers what lessons these debates might hold in the context of pension fund investments.

This context is a very different one in key respects. Firstly, *company* directors’ duties are owed to the company – not to any particular stakeholder, even the shareholders. By contrast, pension fund trustees do not owe their legal duties *to the fund* – their obligation is to the *beneficiaries*. The relationship may be similar in the sense that the beneficiary provides some of the capital, just as shareholders – pension funds included – provide the capital for companies. But the relationship between the beneficiary and the fund is much more fundamental: the fund exists solely for the purpose of providing the beneficiary with retirement benefits. UNEP’s ‘Fiduciary II’ report referred to “*the special relationship between trustees and beneficiaries*” to suggest that trustees’ duties might be “*more extensive and long-term*” than those of company directors.¹² As such, beneficiaries arguably have a greater claim to primacy than shareholders.

¹¹ Archived documents available online at <http://webarchive.nationalarchives.gov.uk/+http://www.berr.gov.uk/bff/co-act-2006/ctr-review/page22794.html> (accessed on 09/03/11) ¹² UNEP-FI, July 2009, ‘*Fiduciary responsibility: Legal and practical aspects of integrating environmental, social and governance issues into institutional investment*’, p24

Most of the time company directors take their principal duty to be to make money for shareholders, but that is not the only significant relationship a company has. It has a core business - it provides goods or services, it might be a retailer or an oil major or a pharmaceutical company. From these activities arise the various claims of the employees who contribute their labour to make that activity possible, or the consumers who purchase the company's products. It is hard to think of parallel stakeholder relationships in a pensions context. Indeed, the only stakeholder interests that easily transfer across from company debates are those of the wider community and environment who are impacted by the organisation's activities.

Having said this, the current relationship between trustee and beneficiary is not entirely binary. The employer is a legitimate stakeholder in occupational pension schemes, by virtue of their financial contributions.¹³ This is recognised in their rights to be consulted over key decisions such as the preparation of the Statement of Investment Principles,¹⁴ and to nominate trustees. In this sense, pluralism is built into the decision-making processes of these fiduciary investors. It is also interesting to note that much of the discourse around the UK Stewardship Code has focussed on investors' "governance responsibilities",¹⁵ with the implication that these 'responsibilities' are owed to investee companies at least as much as to beneficiaries. Indeed, the concept of 'stewardship' often seems to be interpreted in terms of investors' role as 'stewards' of their investee companies,

rather than of the assets entrusted to them by beneficiaries. Strangely, this discourse does not seem to have prompted widespread objections from investors that such an approach is incompatible with their fiduciary obligations - although any suggestion of responsibility for, say, their stewardship of the environment would be unlikely to meet with such a sanguine reaction.

The second respect in which the pensions context differs from that of companies is in their existing governance structures. Debate on stakeholder approaches has generally focussed on the desirability of bringing additional interests into an organisation's decision-making. One of the key arguments against the stakeholder approach has been that such a pluralistic process increases transaction costs and prevents quick and effective decision-making. Yet transferring this to a pensions context implies that beneficiaries, like shareholders, are currently the one stakeholder with a 'seat at the table'. As we saw in chapter 5, in fact the reverse is true: the legal status of beneficiaries has historically been passive, and, as Benjamin Richardson has highlighted, even SRI funds "*seldom demonstrate the level of transparency and participation they demand of the corporations that make up their portfolios.*"¹⁶ In the UK, beneficiaries do now have the right to nominate one-third of a scheme's trustees (with reserve powers in legislation for the government to increase this to one-half)¹⁷ - but this is still far from mirroring the level of control enjoyed by shareholders at company AGMs.

¹³ Richardson, B.J. 'From Fiduciary Duties to Fiduciary Relationships: Responding to the Will of Beneficiaries,' *Journal of Sustainable Finance and Investment* (2011) 1: 1-15 ¹⁴ The Occupational Pension Schemes (Investment) Regulations 2005, SI 2005/3378, Regulation 2(2)(b) ¹⁵ See FRC, 2010, 'The UK Stewardship Code', p1 ¹⁶ Richardson, B.J. 'Keeping Ethical Investment Ethical: Regulatory Issues for Investing for Sustainability', *Journal of Business Ethics* (2009) 87:555-572 ¹⁷ Sections 241(1) and 243(1), Pensions Act 2004

Problems with the stakeholder approach

It would seem difficult to justify extending decision-making rights to other stakeholders when the beneficiaries to whom existing legal obligations are owed do not have similar rights. Of course, it might be possible to argue that beneficiaries' right to nominate trustees should be extended to other stakeholders. But such radical pluralism could indeed complicate and compromise effective decision-making. In addition, such an approach suffers from what David Howarth¹⁸ characterises as the 'who speaks?' problem: who precisely should have the right to nominate trustees on behalf of external interests? This problem might be relatively easy to resolve in a company context when the stakeholders in question are employees, or even the local community. It is much more difficult in a pensions context when the key external interests at play are so broad and nebulous – the public interest, the economy, the environment. Short of allowing government or environmental NGOs a seat at the table, it is difficult to see how these interests could be directly represented at board level.

It has also been suggested (for example, by American academic Benjamin Richardson) that stakeholder rights could be effected by obliging trustees themselves to consider third party interests when making decisions.¹⁹ But this method still does not overcome the objection that beneficiaries do have a special status, and a special entitlement, in relation to the investment of their assets. Fiduciary obligation exists to ensure that beneficiaries' agents are

held to a high standard of care and act responsibly when entrusted with another's interests. As Richardson has conceded, full stakeholder obligations could radically undermine this purpose: *"where a fiduciary must consider numerous conflicting interests without any way of prioritising among them, any decision taken that is not blatantly self-interested possibly becomes defensible."*²⁰

“Is there a way to free trustees (and other fiduciary-like institutional investors) to consider the wider impacts of their actions whilst preserving the primacy of the beneficiaries' interests?”

The enlightened fiduciary model: The Companies Act 2006

If stakeholder rights are not desirable in a pensions context, is there a way to free trustees (and other fiduciary-like institutional investors) to consider the wider impacts of their actions whilst preserving the primacy of the beneficiaries' interests? Section 172 of the Companies Act 2006 provides one possible model for such a move.²¹

¹⁸ In presenting to our fourth seminar, September 2010, 'Beneficiaries redefined' ¹⁹ See for example Richardson, 2009, op cit ²⁰ Ibid, p565 ²¹ Section 172 is often described as setting out directors' fiduciary duties. The fiduciary duties of company directors are similar in nature to those of trustees, but are not exactly the same.

Box A: Directors' duties under the Companies Act 2006

172 Duty to promote the success of the company

- (1) *A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—*
- (a) *the likely consequences of any decision in the long term,*
 - (b) *the interests of the company's employees,*
 - (c) *the need to foster the company's business relationships with suppliers, customers and others,*
 - (d) *the impact of the company's operations on the community and the environment,*
 - (e) *the desirability of the company maintaining a reputation for high standards of business conduct, and*
 - (f) *the need to act fairly as between members of the company.*

Presenting at our seminar, David Howarth pointed out that these provisions arose out of a process in which the stakeholder approach was explicitly rejected: although often referred to as 'stakeholder provisions', they do not confer any rights on stakeholders to enforce directors' duties, either by participating in decision-making or by challenging decisions through the courts. Instead, they are based on the concept of 'enlightened shareholder value':²² the directors' duties remain to the company, but the legislation clarifies

that responsible business practices and consideration of the company's wider impacts are a legitimate part of fulfilling those duties. One seminar participant characterised the provisions as follows:

"I don't think anyone believed that the new duties were in contradiction to the existing case law, but the aim was to encourage companies to take a long-term view, achieving success through safeguarding their stakeholders' interests, rather than a sort of slash and burn approach, which can also generate profits. It was trying to encourage companies to take the high road, if you like, rather than the low road, to company success - accepting that there is a viable path along each way."

David Howarth went further, suggesting that the provisions had never been intended to catalyse profound change in company behaviour, but that their function has been primarily 'defensive': they protect directors who want to take stakeholder interests into account from legal challenges by, for example, later successful takeover bidders or administrators in insolvency, who might accuse them of breaching their duties by not maximising short-term profits.

“ At present, the Companies Act ethos of enlightened shareholder value is in direct conflict with the perception of these shareholders that their legal obligations actively prevent them from taking an enlightened approach ”

²² See DTI, March 2005, *Company Law Reform White Paper*, p5

This ‘defensive’ characterisation is particularly interesting when applied to pensions. The current law on fiduciary obligation does indeed appear to be interpreted by many investors as, in effect, forcing them to take ‘the low road’ to fulfilling their beneficiaries’ interests. As one seminar participant put it, statutory clarification that “*fiduciary duty isn’t the handcuffs that people tend to think it is*” might be exactly what is needed. In this context, section 172 may provide an extremely appropriate model for parallel provisions giving fiduciary investors the freedom to take a more enlightened approach to their responsibilities. The fact that fiduciary investors are themselves shareholders makes this case all the more compelling. At present, the Companies Act ethos of enlightened shareholder value is in direct conflict with the perception of these shareholders that their legal obligations actively prevent them from taking an enlightened approach.

Applying Section 172 principles to institutional investors

What would such an enlightened fiduciary provision for institutional investors entail? The specific factors to which section 172 requires directors to ‘have regard’ do not all transfer across neatly to an investment context. Some are relevant, some are not - and some additional factors might be relevant to fiduciary investors which do not arise in a company context. Below we consider briefly some candidates for inclusion, and set out an illustrative model of what a parallel provision might look like.

The likely consequences of any decision in the long-term

The first factor listed in section 172 is acutely relevant in an investment context. As we saw in chapter 1, prevailing

interpretations of fiduciary obligation may actually have exacerbated market tendencies towards short-termism, thereby jeopardising the long-term best interests of pension fund beneficiaries. Clarifying the long-term nature of fiduciary obligations would serve the twin objectives of securing effective pension provision and encouraging more stable and sustainable financial markets.

The impact of the fund’s activities on the stability of the financial system and on the economy

This is not included in the provisions on directors’ duties, although in the wake of the financial crisis, FairPensions has suggested that it might be a useful addition.²³ In an investment context, it is of course even more immediately relevant - particularly in light of growing evidence, discussed above, that some long-term fiduciary investors are partaking in risky or short-termist strategies which may compromise financial stability without serving beneficiaries’ long-term interests. It is interesting to note that institutional investors in some jurisdictions - for instance, French and German mutual funds - owe statutory duties to act “*in the sole interest of investors and of the integrity of the market*”.²⁴

“Some long-term fiduciary investors are partaking in risky or short-termist strategies which may compromise financial stability without serving beneficiaries’ long-term interests”

²³ See FairPensions, Sept 2009, *Submission to the Walker Review of Corporate Governance in Banks and Other Financial Industry Entities*, p7 ²⁴ See UNEP-FI, 2005, ‘*A legal framework for the integration of environmental, social and governance issues into institutional investment*’, p58 and p62

The impact of the fund's activities on the community and the environment

Again, this element of section 172 has clear applicability in an investment context, especially if broadened to cover environmental, social and governance (ESG) considerations generally. As discussed in chapter 3, ESG issues will often have a material impact on returns or on the fund's level of risk. Where this is the case, they should be integrated into investment analysis - although in practice this is proving slow to enter the mainstream. Where social or environmental issues are not obviously financially material, then, as discussed in Chapter 4, it appears that such issues may lawfully be taken into account as long as this does not compromise beneficiaries' financial interests. A formulation based on section 172 would help to preserve this balance while clarifying that trustees are not automatically bound to disregard such considerations.

The desirability of maintaining a reputation for high standards of business conduct

This element of section 172 could also be usefully translated, with some changes, to a trust context. In particular, it would be desirable finally to put an end to the principle, endorsed in *Cowan v Scargill*, that “trustees may even have to act dishonourably (though not illegally) if the interests of their beneficiaries require it.”²⁵ Whether or not this doctrine is still appropriate in relation to private trusts (which fall outside the scope of this review), it is indefensible in the case of pension schemes and other institutional investors that play a public role.

The views of beneficiaries

As discussed in chapter 5, pension savers' status as the providers of capital, together with the shift to DC arrangements where beneficiaries bear the investment risk, creates a compelling case for enhancing beneficiaries' rights to have their views considered, whether it be their ethical preferences or their risk appetite.

The inclusion of this factor could also help to resolve the ‘remoteness’ problem discussed in Chapter 4. Currently, pension scheme trustees are arguably prevented from acting as ‘good citizens’ if the scheme’s assets alone cannot have a material impact on a given macro-economic or environmental issue. Allowing trustees to have regard to their beneficiaries’ express or implied wishes would free them to act in this enlightened manner with their beneficiaries’ support.

The need to act fairly as between members of the company

This provision of section 172 should undoubtedly be mirrored in any fiduciary equivalent, as it would reaffirm the fiduciary’s duty of impartiality, not least in relation to the need for intergenerational equity (see Chapter 1).

The non-financial interests of beneficiaries

As discussed in Chapter 4, there would be value in formalising the recognition in the *Cowan v Scargill* judgement that “‘benefit’ is a word with a very wide meaning”, and in making it clear that, subject to the general duty of prudence, trustees are free to take into account broader considerations that may affect beneficiaries’ quality of life. This would liberate fiduciaries from the highly restrictive interpretation of ‘best interests’ which has become standard, without compromising their duty to protect members’ financial interests.

²⁵ Page 761d. The judge went on to cite *Buttle v Saunders* [1950] 2 All ER 193, where trustees were held to be obliged to “gazump” in the interests of their beneficiaries.

Box B: Specimen draft of a Fiduciary Institutional Investor Equivalent of Section 172 Companies Act 2006

“(1) In the exercise of his investment functions a fiduciary must act in the way he considers, in good faith, would be most likely to be for the benefit of his beneficiaries as a whole, and in doing so have regard (amongst other matters) to -

- (a) the likely consequences of any decision in the long term,*
- (b) the impact of his investment activities on the stability of the financial system and on the economy,*
- (c) environmental, social and governance considerations, including the environmental and social impact of his investment activities,*
- (d) the desirability of his maintaining a reputation for high standards of commercial conduct,*
- (e) the desirability of ascertaining and of taking into account the views, including the ethical views, of beneficiaries in relation to his investment policy, and*
- (f) the need to act fairly as between the beneficiaries, including as between present and future beneficiaries.*

(2) For the purposes of this section, the expression “benefit” includes -

- (a) financial benefit; and*
- (b) any non-financial benefit which the fiduciary considers can be conferred on beneficiaries without any material prejudice to their financial benefit.”*

N.B. It is emphasised that this is only an indicative draft that is put forward as a basis for further discussion.

As has been argued in previous chapters, allowing consideration of these factors does not constitute a major departure from the existing legal position. Indeed, most of them are not strictly ‘stakeholder’ issues at all, but simply a restatement of the duty to serve beneficiaries’ best interests and to take account of all relevant considerations, cast in light of the concept of enlightened shareholder value. Of course, this begs the question whether legal change is really necessary. If considering these issues is part of the fiduciary duty to serve beneficiaries’ best interests, surely fiduciary investors can be encouraged to do so without a change in the law?

“It is difficult to see how this perceived legal barrier can be overcome without statutory clarification - freeing trustees to use their judgement, in good faith, of how they can best serve their beneficiaries’ interests”

The counter-argument to this is two-fold. Firstly, although the arguments for this more enlightened and responsible approach are now well-rehearsed, in practice it has yet to enter the mainstream, as we have seen throughout this report. Secondly, part of the reason for this slow progress is the deep entrenchment of a highly restrictive interpretation of the current legal position. Even if fiduciary obligations do not present a barrier to enlightened behaviour, it clearly is perceived as a barrier by many trustees.²⁶

²⁶ One seminar participant who works with trustees on a regular basis commented that “Trustees do regularly report this being an issue which is put to them in those terms.”

It is difficult to see how this perceived legal barrier can be overcome without statutory clarification - freeing trustees to use their judgement, in good faith, of how they can best serve their beneficiaries' interests, rather than feeling that the law restricts them to a particular interpretation or even to a particular investment strategy. A section 172 equivalent would provide such clarification in two key respects. Firstly, just as section 172 allows directors to take an enlightened approach to securing company success, it would allow fiduciaries to take an enlightened approach to securing their beneficiaries' best interests - both by paying attention to ESG issues that might affect returns, and by giving due weight to beneficiaries' ethical preferences and non-financial interests. Secondly, it would allow consideration of what have been termed 'collateral benefits' - for instance, to the community or the environment - when this does not compromise beneficiaries' interests.

And, just as section 172 does not depart from the principle that directors' duties are owed to the company, it would preserve the principle that fiduciary obligations are owed to beneficiaries. As such, unlike more radical stakeholder approaches, it would not interfere with the basic nature of the fiduciary relationship.²⁷ Neither would it compromise fiduciary investors' duty to seek good returns for beneficiaries, since the overriding requirement of trust law - that trustees must exercise their powers for the purposes of the trust - would remain. It would, however, enable them to place this goal in the context of a more rounded understanding of beneficiaries' interests, and would make clear that they are not obliged to pursue short-term profit at all costs without any regard for the wider consequences.

Short of clarification along these lines, it seems likely that the perceived legal position will continue to stifle innovation and impede the development of sustainable practices.

International precedents

There is no direct precedent for applying section 172 - which was itself a pioneering provision - to fiduciary investors. However, various jurisdictions have pursued similar objectives or have confirmed that these are not incompatible with existing fiduciary obligations. For instance, the American courts have held that fiduciary obligations to beneficiaries do not prohibit the consideration of 'collateral benefits' to others. In the case of *Donovan v Walton*, the court confirmed that

*"ERISA ... simply does not prohibit a party other than a plan's participants and beneficiaries from benefiting in some measure from a prudent transaction with the plan."*²⁸

In other words, third party interests can be taken into account as long as this does not compromise the interests of beneficiaries. In some ways this resembles the 'ethical tie-break' principle discussed in chapter 4 - albeit with different interests at play. It also reflects a wider shift in fiduciary obligations, away from the original 'sole interests' standard - which required fiduciaries to act in the sole interests of beneficiaries - and towards a 'best interests' standard. This recognises that there is no reason others should not benefit from decisions where this is in line with beneficiaries' best interests, but preserves the principle that, in case of a conflict, the beneficiaries' interest must always be paramount. Allowing trustees to take payment for their work is also part of this wider trend.²⁹

²⁷ Indeed, Benjamin Richardson has made clear that he does not regard this as a true stakeholder model, since *"the duty of loyalty... would remain to the fund's beneficiaries."* Richardson 2009, *op cit*, p565 ²⁸ *Donovan v Walton*, 609 F Supp 1221 (DC Fla 1985), 1245. Cited in Richardson 2011, *op cit* ²⁹ See Langbein, JH. *'Questioning the Trust Law Duty of Loyalty: From Sole Interest to Best Interest.* Yale Law Journal 2005: 114, 929-990

Some jurisdictions have gone further along the road from permission to obligation, enacting requirements for ethical or responsible investment - although such requirements have generally only been applied to public sector pension funds. For instance, in 2000 Sweden introduced a requirement for state pension funds to take “*environmental and social considerations... into account without relinquishing the overall goal of a high return on capital.*”³⁰ Other examples include France, Norway and New Zealand.³¹ Although these requirements are framed in stronger terms than we propose, they still preserve the overall duty to seek a good investment return. In doing so, they demonstrate that it is possible to design provisions that recognise the public interest in responsible investor behaviour, without creating the kind of anarchic mess which many associate with stakeholder approaches, and without preventing fiduciaries from prioritising the interests of their beneficiaries.

Recommendation: *BIS should introduce a provision parallel to section 172 of the Companies Act for institutional investors.*

‘Soft law’: disclosure and accountability

Any consideration of statutory change might need to be supplemented by ‘soft law’. Once again, company law may offer lessons in this respect, and parallels can be drawn with current debates about corporate governance (see table below).

Method	Companies	Pensions
Voluntary codes	Corporate Governance Code	Stewardship Code
Engagement	Shareholder rights	Beneficiary rights
Disclosure & transparency	Narrative reporting	Voting & engagement disclosure

Voluntary codes

The Stewardship Code is a welcome step forward in encouraging responsible ownership practices on the part of institutional investors. As we have seen, the Stewardship Code arose precisely from a post-financial-crisis recognition that institutional investors’ behaviour has far-reaching consequences for financial stability and corporate risk-management. However, the Code’s focus is almost exclusively procedural, and avoids laying down any objective provisions as to *how* investors should exercise their ownership rights. For instance, the phrase ‘long-term’ appears only once in the preface to the Code and nowhere in the Code itself.

³⁰ Sweden, National Pension Insurance Funds (AP-Funds) Act, 2000: 192, as amended. Cited in Richardson 2009, *op cit*, p559 ³¹ Richardson, 2009, *op cit*, p559

Concerns were raised at the seminar that efforts to promote responsible shareholder engagement might fail in their objectives without some kind of substantive content:

“[These approaches assume] that shareholders use their powers and influence with companies to encourage responsible and sustainable behaviour, when very much in the run-up to the financial crisis one can see that it was the opposite. Northern Rock was a darling of the investment community; Lloyds Bank, a prudent bank, was not.”

In other words, the failings from which the Stewardship Code arose were not just those of ‘absentee landlords’, but also of the active exercise of shareholder rights to encourage risky behaviour. This may add weight to the case for a section 172 equivalent, in order to provide substantive content to the idea of responsible ownership and supplement the efforts of the Code. It may also strengthen the case for amendments to the Code itself.

“The failings from which the Stewardship Code arose were not just those of ‘absentee landlords’, but also of the active exercise of shareholder rights to encourage risky behaviour”

Engagement

One of the arguments for limited stakeholder regulation of companies has been that the UK corporate governance model emphasises the exercise of shareholder rights as a means of holding directors accountable. So, asked one seminar participant, “to what extent can you apply those [rights] to the relationships covered in pension law, the relationships between beneficiaries and funds, trustees and fund managers?”

This question is particularly interesting given the dual role of pension funds, who are themselves the shareholders in question. Although investors rely on democratic decision-making structures and participation rights to underpin their engagement with investee companies, they have historically been reluctant to extend similar rights to their beneficiaries one step along the investment chain.³²

The possibilities and limitations of member involvement are discussed in depth in chapter 5. As above in relation to the Stewardship Code, any further procedural rights would benefit from the underpinning of a section 172 equivalent, to provide a clear and substantive standard against which to hold decision-makers accountable.

³² Richardson 2009 (*op cit*)

“ Although investors rely on democratic decision-making structures and participation rights to underpin their engagement with investee companies, they have historically been reluctant to extend similar rights to their beneficiaries one step along the investment chain ”

It has also been suggested, most notably by Lord Myners, that enlightened share-ownership could be encouraged by changes to the shareholder rights of institutional investors themselves - for instance, by according preferential voting rights to those with long-term holdings. Concerns have been expressed that the creation of a ‘two-tier’ system of shareholder rights would be a radical and undesirable departure from the UK corporate governance framework.³³ On the other hand, it has been acknowledged that “shareholders who do not exercise ... governance oversight are effectively free-riding on the governance efforts of those who do.”³⁴ The question of whether there is scope to incentivise responsible investor behaviour through the corporate governance framework itself is perhaps one that deserves further consideration.

Disclosure and transparency

Of course, the first thing beneficiaries need in order to meaningfully engage with their fiduciaries is information. But in addition, recognition of a wider public interest in investor behaviour would seem at the very least to justify greater public disclosure regarding their activities, including their exercise of ownership rights and their implementation of policies regarding ESG issues. Transparency is relevant both to the substantive question of how to encourage responsible behaviour, and to the question of accountability, both of which were central to the stakeholder debates in company law. As David Howarth points out, section 172 did not create any direct accountability to external stakeholders, since they did not acquire rights to challenge company decisions through the courts (although the granting of third party rights of action does have precedents elsewhere).³⁵ The development of narrative reporting requirements, whereby directors publicly explained how they had fulfilled their duties under section 172,³⁶ was in part justified by this interest in greater accountability.

A similar principle has been recognised for investors by the UK government and regulators. The Stewardship Code encourages public disclosure of voting records by institutional investors.³⁷ Although this duty has been said to fall on asset managers rather than asset owners, this appears to be largely for logistical reasons rather than because of any principled difference based on pension funds’ fiduciary obligations.³⁸ In a speech to the Association of British Insurers, government minister Edward Davey

³³ See for example Financial Times, 3 August 2009, ‘Investors wary of Myners’ voting rights idea’ ³⁴ Sir David Walker, 2009, ‘A review of corporate governance in UK banks and other financial industry entities: Final Recommendations’, para 5.8 ³⁵ See for example the Contracts (Rights of Third Parties) Act 1999 ³⁶ The business review - section 417, Companies Act 2006. ³⁷ FRC, 2010, *The UK Stewardship Code*, Principle 6 ³⁸ See NAPF, 2010, ‘UK Stewardship Code: Guidance for Investors’.

reiterated that the Code's encouragement of public voting disclosure was 'crucial', adding:

*"Voting at company meetings is one of the most effective ways of providing long-term stewardship - I believe it is therefore important that all institutional investors disclose their voting records."*³⁹

This position was reiterated by the government in a written parliamentary answer some ten days later.⁴⁰ The government has reserve powers to make voting disclosure mandatory⁴¹ (something also being considered by the European Commission).⁴² FairPensions' 2010 survey of leading asset managers, which found that disclosures vary enormously in quality with some managers continuing not to disclose at all, suggests that this option should at the very least be kept under review as a means of ensuring a level playing field between investors and comparable information for the markets.⁴³

A less well-rehearsed question is whether public disclosure might extend to information about engagement as well as voting. FairPensions' survey found that such disclosure had increased significantly since 2008, but that 41% of managers still do not disclose any information about their engagement activities.⁴⁴ It has been objected that engagement disclosure would compromise commercial relationships - but it would be unlawful for companies to provide investors with price-sensitive information without disclosing it to the whole market, and, in any case, there appears no obvious reason that information about the questions managers were asking (as opposed to the answers they received) should be commercially

“ 41% of managers still do not disclose any information about their engagement activities ”

sensitive. As the survey concluded, *"the level of public disclosure made by managers such as Newton, Threadneedle and F&C without any apparent damage to relationships with investee companies would seem to effectively counter concerns about the risks of disclosing engagement activities."*⁴⁵

Finally, David Howarth notes that members of occupational pension schemes do not have a choice of provider, and that therefore *"the information route seems even less effective for pensions than for companies, because there is no market mechanism."*⁴⁶ As discussed in chapter 5, where members do not have a choice, their right to visibility on the management of their money is arguably all the more important. But this comment also highlights the importance of ensuring that any new requirements for greater transparency apply equally to all kinds of pension provision, including customers of insurance companies who do have a choice as to where they invest their pension. In this context, it is somewhat concerning that the FSA recently deemed it unnecessary to require retail investment providers (as opposed to those with institutional clients) to disclose their commitment to the Stewardship Code.⁴⁷

³⁹ Edward Davey, Minister for Employment Relations, Consumer and Postal Affairs, 15 September 2010, *Speech to the Association of British Insurers*. Available online at www.bis.gov.uk/news/speeches ⁴⁰ HL Deb, 27 September 2010, c490W ⁴¹ Section 1277, Companies Act 2006 ⁴² See footnote 9 ⁴³ FairPensions, 2010, 'Stewardship in the Spotlight' ⁴⁴ Ibid, p7 ⁴⁵ Ibid ⁴⁶ In presenting to our fourth seminar ⁴⁷ FSA, November 2010, *Handbook Notice 104*, p20

Recommendation: *BIS/Treasury should clearly state their willingness to make use of reserve powers to introduce mandatory voting disclosure if voluntary initiatives do not prompt sufficient improvements by a specified date. They should also explore other ways of improving transparency and accountability among institutional investors.*

Pension funds and tax relief - taxpayer as stakeholder

As David Howarth points out, *“Enlightened shareholder value is entirely compatible with more regulation of companies, rather than changes to the internal corporate governance of companies.”*⁴⁸

In the same way, rejection of the radical stakeholder approach to fiduciary duty is entirely compatible with government action to proscribe or discourage particular investment behaviours that threaten the public interest. The UK government arguably has a particular interest in the behaviour of British pension funds due to the tax relief enjoyed by pension savings, which amounted to £37.6bn in 2007-08.⁴⁹ The government’s decision to restrict tax relief is projected to save around £4bn per annum⁵⁰ - in other words, pensions tax relief will remain a highly significant item of public expenditure, still over £30bn.

Generally, the public interest this creates in the activity of pension providers is likely to coincide with beneficiaries’ interests. Firstly, the presumed policy objective of pensions tax relief is to encourage private pension saving, thereby reducing dependence on the state in old age. If

pension providers fail to secure a decent retirement income for their beneficiaries, this objective has failed and the state arguably pays twice. Secondly, the state clearly has an interest in ensuring that these subsidised savings are not invested in a way which destabilises the economy or otherwise creates demands on the Exchequer. It is hard to think of a situation where this would not also be in beneficiaries’ interests: economic instability has myriad implications for the average beneficiary’s quality of life, almost regardless of its effect on their pension pot. The question then is whether the state is in a better position than beneficiaries themselves to defend these common interests, and whether state contributions through tax relief give it standing to do so.

“Economic instability has myriad implications for the average beneficiary’s quality of life, almost regardless of its effect on their pension pot”

⁴⁸ In presenting to our fourth seminar ⁴⁹ Murphy R., 2010, ‘Making Pensions Work’, Finance for the Future LLP: p17
⁵⁰ HM Treasury, December 2010, ‘Restricting Pensions Tax Relief’. Available on HMT website at www.hm-treasury.gov.uk/Finance_Bill_2011.htm (accessed 10/03/11)

To take a practical case study, it has recently been proposed that fine-tuning of tax relief itself could provide an appropriate policy lever for incentivising long-term investment behaviour. Paul Woolley of the LSE has suggested that tax relief could be made conditional on capping spiralling level of ‘churn’, or portfolio turnover.⁵¹ According to figures quoted by Andrew Haldane of the Bank of England, in 1940 the mean duration of US equity holdings by investors was around seven years; by 2007, it was around seven months.⁵² UK pension funds have been far from exempt from this global trend. There is evidence that some equity funds being marketed to UK pension schemes have turnover levels upwards of 300%.⁵³ It is difficult to see what benefit this brings to beneficiaries with long-term investment horizons. Indeed, studies have shown that higher turnover is associated with progressively higher transaction costs which can significantly reduce returns to the ultimate investor.⁵⁴ The Pensions Regulator has also highlighted the potentially negative impact of high turnover as a key factor for trustees to understand in controlling scheme costs.⁵⁵

If the benefits of churn are flowing to brokers and other intermediaries rather than to pension savers, it is also difficult to see how this constitutes good value for the government’s tax relief. As Woolley notes, UK tax law already provides that tax relief only applies to investment income: HMRC guidance states that *“income from a trading activity undertaken by a registered pension scheme is not investment income and so does not qualify for this tax exemption”*⁵⁶ Distinguishing ‘trading’ from ‘investment’ income is a complex matter,

and these provisions have rarely been implemented. But Woolley argues that *“this is the model to follow and the time to start.”*⁵⁷

It must be acknowledged that the idea of imposing conditionality on tax relief is far from simple. Since the tax relief applies to member and employer contributions, any such provision would need to be carefully designed to avoid the charge that it was penalising the ordinary pension saver rather than those making the investment decisions. Of course, discouraging excessively high portfolio turnover is intended to protect pension savers as much as anything else - but it might be difficult to argue that the benefits of encouraging lower churn outweighed the costs of losing all their tax relief. This need not rule out the idea of incentivising long-term investment through the tax system; but it does mean that any such action would need to be carefully calibrated to ensure that the likely benefits to members were not outweighed by unfair costs. The existing legal provisions may provide a useful model in this regard, since the loss of tax relief applies only to that portion of income deemed to be ‘trading income’, rather than to the whole fund.

Of course, there are other policy tools available to government. One is simply to proscribe investment behaviours which are deemed dangerous or irresponsible. As we saw in chapter 1, until relatively recently, fiduciary investors were restricted by law to certain classes of investments that were deemed ‘safe’. While nobody is suggesting a return to this legal position, it is interesting that The Pensions Regulator has recently hinted at the revival of restrictions on asset classes for pension

⁵¹ Woolley P., 2010, *op cit* ⁵² Haldane A., 2010, ‘*Patience in Finance*’, p16 ⁵³ Based on Simplified Prospectuses of equity funds; further details available on request. ⁵⁴ See for example Frontier Investment Management LLP Research, 2007, ‘*When is a total expense ratio not a total expense ratio*’, p3; Woolley P., 2010, *op cit*, p134 ⁵⁵ TPR, 2011, ‘*Enabling good member outcomes in work-based pension provision*,’ p20 and p36 ⁵⁶ HMRC Registered Pension Schemes Manual 04103010 - Technical Pages: Taxation: Scheme investments: Exemption from income tax ⁵⁷ Woolley P., 2010, *op cit*, p141.

funds engaging in risky strategies in an attempt to fill their deficits.⁵⁸ Levels of turnover may be another instance where there is a case for regulatory action. The government interest in good scheme governance, arising both from tax relief and from the existence of the Pension Protection Fund, also suggests that The Pensions Regulator's role should be seen not just in consumer protection terms but also as a defender of the public interest.

The softest form of government intervention would be to mandate transparency on levels of turnover. One seminar participant, herself a trustee, revealed that she had attempted to access information about turnover and associated fees in relation to her own fund, but that their asset managers had not provided it. If even trustees - let alone beneficiaries or the general public - are unable to access such information, there would appear to be a clear case for greater transparency to ensure that fiduciaries are in a position to fulfil their responsibilities.

Recommendation: *As part of its review 'A long-term focus for corporate Britain', BIS should explore ways to ensure that pension funds are acting as long-term investors and avoiding high levels of 'churn' which create transaction costs for beneficiaries and generate financial instability. Possible tools could include tax incentives, regulations and disclosure requirements.*

Chapter Summary

The status of pension funds and other fiduciary investors as major economic actors creates a public interest in their behaviour which is difficult to deny. This chapter considered various ways in which that interest could be defended.

The most radical - a 'stakeholder' model of fiduciary obligation - was rejected on the grounds that there are compelling reasons to retain the primacy of the beneficiaries' interests which characterises the fiduciary relationship. Instead, it is suggested that the directors' duties under the Companies Act 2006 could provide a useful model for an 'enlightened fiduciary' standard, freeing investors to take account of the long-term and wider impacts of their activities insofar as this is consistent with protecting beneficiaries' interests. Various supplementary mechanisms were discussed for further encouraging 'enlightened' investor behaviour, including member engagement, voluntary codes and improved transparency.

Finally, it was suggested that the tax relief enjoyed by pension savings creates a public interest in responsible investment behaviour which will generally align with beneficiaries' interests. In the case of some investment behaviours, such as levels of portfolio turnover, the government may be in a stronger position than beneficiaries themselves to defend this common interest. Tax incentives, regulation and disclosure requirements are all tools through which the public interest could be protected without impinging on fiduciary obligations or relationships.

⁵⁸ Sir David Norgrove, Dec 2010, Speech to National Association of Pension Funds Annual Trustee Conference

Summary of Recommendations

- *BIS should introduce a provision parallel to section 172 of the Companies Act for institutional investors.*
- *As part of its review 'A long-term focus for corporate Britain', BIS should explore ways to ensure that pension funds are acting as long-term investors and avoiding high levels of 'churn' which create transaction costs for beneficiaries and generate financial instability. Possible tools could include tax incentives, regulations and disclosure requirements.*
- *BIS/Treasury should clearly state their willingness to make use of reserve powers to introduce mandatory voting disclosure if voluntary initiatives do not prompt sufficient improvements by a specified date. They should also explore other ways of improving transparency and accountability among institutional investors.*

Conclusion & Recommendations

A fresh look at fiduciary obligation has much to contribute to some of the biggest policy challenges we face: preventing another financial crisis, providing for our ageing population, and moving towards a low-carbon economy. There is an urgent need to strip away the myths and rediscover what fiduciary obligation is really about - and how these principles can be applied to a world that has changed radically in ways the law has only partially caught up with. In addition to our specific recommendations on particular issues, our overarching conclusion is that the government must conduct a review of investors' fiduciary obligations. Its goal should be to ensure the legal framework is serving its purpose: to protect us all from irresponsible, short-sighted or self-serving behaviour by those on whom we depend to act on our behalf.

Although the recommendations set out below are directed towards UK government, regulators and investors, we hope that the conclusions of this report will also be of interest to overseas readers.

Recommendations for Government

- Conduct a fundamental cross-departmental review of investors' fiduciary obligations, both to ensure that this valuable concept remains relevant in the 21st century, and to step back and reconsider whether the law is fulfilling its purpose of protecting beneficiaries. The goal should be to achieve enlightened fiduciary standards of care over all private pension savings and other long-term savings.
- Establish a cross-departmental group to carry forward the outcomes of this review and to act as a nexus for institutional investment issues within government.
- In particular, the review should consider:
 - whether the existing legal framework is ill-equipped to deal with the problem of systemic risk, and whether new law or guidance might be needed to ensure that trustees feel free to take account of systemic issues with implications for their members; and
 - the legal obligations that apply to contract-based pension providers, with the aim of ensuring that standards of care and accountability mechanisms are consistent across the market.

Recommendations for the Department for Work and Pensions

- Issue a comprehensive guide for pension scheme trustees on their fiduciary duties in relation to exercising investment functions, setting out the key relevant obligations and providing guidance on their interpretation.
- Ensure that any new guidance for trustees:
 - provides confirmation that fiduciaries should consider ESG issues which may be financially material. This could be accompanied by more detailed guidance on the respective roles of trustees, asset managers and consultants; and
 - clarifies the relationship between member involvement and the duty of impartiality, and should consider statutory clarification of this point if necessary.
- Provide statutory clarification on the extent to which ethical and social considerations can be taken into account by pension scheme trustees. This would help end current confusion and disagreement as well as over-reliance on often questionable interpretations of a small number of legal decisions with doubtful relevance to contemporary circumstances.

Recommendations for the Department for Business, Innovation and Skills

- Introduce a provision parallel to section 172 of the Companies Act for institutional investors.
- As part of its review ‘A long-term focus for corporate Britain’:
 - facilitate pension providers’ efforts to align asset managers’ incentives with those of their beneficiaries - for instance, through a ‘lab’ enabling experimentation as to the practical form such mandates might take.
 - explore ways to ensure that pension funds are acting as long-term investors and avoiding high levels of ‘churn’ which create transaction costs for beneficiaries and generate financial instability. Possible tools could include tax incentives, regulations and disclosure requirements.
- Clearly state its willingness to make use of reserve powers to introduce mandatory voting disclosure if voluntary initiatives do not prompt sufficient improvements by a specified date. They should also explore other ways of improving transparency and accountability among institutional investors.
- As part of its review ‘The future of narrative reporting’, seek to promote the concept of integrated reporting, and explicitly clarify the need to ensure that environmental and social reporting is forward-looking and strategic rather than being siloed into backward-looking CSR or sustainability reports.

Recommendations for the Treasury

- Take the opportunity presented by the current review of financial regulation to ensure that the regulatory structure is streamlined and delivers equal levels of protection to all pension savers regardless of the form of their pension arrangements.
- Clearly state its willingness to make use of reserve powers to introduce mandatory voting disclosure if voluntary initiatives do not prompt sufficient improvements by a specified date. They should also explore other ways of improving transparency and accountability among institutional investors.

Recommendations for Regulators

Recommendations for the Financial Services Authority/Financial Conduct Authority

- Remind asset managers of their fiduciary status and of the fact that this may entail stricter obligations than those imposed by regulatory rules; seek to improve firms’ understanding and application of fiduciary obligations, with a particular focus on the prevention, management and disclosure of conflicts of interest.
- Confirm that investment consultants are fiduciaries in relation to their clients and work to ensure that these obligations are understood and applied in practice, with a particular focus on the prevention, management and disclosure of conflicts of interest.

Recommendations for The Pensions Regulator

- Take steps to ensure that the training available to trustees on the critical matter of monitoring asset managers is sufficiently robust and independent. There is also a role for trade unions in providing continued support for member-nominated trustees.
- Seek to facilitate and support funds to engage with their members, for instance through the dissemination of model surveys or best practice guidance.
- Small pension schemes should be encouraged and enabled to consolidate, bearing in mind the per member unit costs of running small schemes and the generally higher quality of scheme governance and member communications in larger schemes.

Recommendations for the Financial Reporting Council

- Ensure that future revisions of the Stewardship Code place explicit emphasis on environmental and social issues as well as on governance.
- Seek to promote the concept of integrated reporting and explicitly clarify the need to ensure that environmental and social reporting is forward-looking and strategic rather than being siloed into backward-looking CSR or sustainability reports.

Recommendations for investors Recommendations for all pension providers

- (For DC providers) Offer an ethical option based on an assessment of members' ethical preferences.
- Consult with members and encourage and welcome member engagement, including by providing full and open disclosures on their investment policies and practices.
- Consider how to embed appropriate incentives in contracts with asset managers - for instance, by incorporating longer-term performance measures on a wider range of factors than benchmark relative financial performance.

Recommendations for trustees

- Seek to avoid and manage conflicts of interest not just within the trustee board itself, but also among their service providers. In particular, funds should request information regarding the policies their asset managers and consultants have in place to ensure that specific relevant conflicts are properly managed.
- When asked by members to consider an ethical issue, perform an analysis of its effect on their portfolio, in line with the 'ethical tie break' principle. Currently many funds wrongly invoke fiduciary duty to justify a refusal even to consider a non-financial issue.

Recommendations for insurance companies

- Devote more attention to outreach, communication and accountability to policyholders, for instance by organising roadshows.

Glossary of Terms and Abbreviations

BIS- UK Government Department for Business, Innovation and Skills

DWP- UK Government Department for Work and Pensions

FRC- Financial Reporting Council

FSA- Financial Services Authority

FCA- Financial Conduct Authority

IIGCC- Institutional Investors Group on Climate Change

NAPF- The National Association of Pension Funds

NEST- The National Employment Savings Trust

PADA- The Personal Accounts Delivery Authority

TPR- The Pensions Regulator

UNPRI- Principles for Responsible Investment

Contract Based Pensions- The employer appoints a pension provider, often an insurance company, to run this type of scheme. Employees take out a contract (also known as a policy) with the provider.

DB Schemes- Defined benefit scheme. A scheme in which the benefits are defined in the scheme rules and accrue independently of the contributions payable and investment returns. Most commonly, the benefits are related to members' earnings when leaving the scheme or retiring, and the length of pensionable service. Also known as 'final salary' or 'salary-related' scheme.

DC Schemes- Defined contribution scheme. A scheme in which a member's benefits are determined by the value of the pension fund at retirement. The fund, in turn, is determined by the contributions paid into it in respect of that member, and any investment returns. Also known as 'money purchase' scheme.

Individual Personal Pensions (Retail Pensions) - With a personal pension people pay regular monthly amounts or a lump sum to the pension provider who will invest it on their behalf. The fund is usually run by financial organisations such as building societies, banks, insurance companies or unit trusts.

Occupational Pensions- Occupational pension schemes (also called Company Pension schemes) are when the employer organises a pension scheme for its employees. It can either be set up as a trust and run by trustees or entrusted to an insurance company.

Trust Based Pensions- Schemes established by an employer to provide benefits for employees and others and managed by trustees who collect the contributions, hold the scheme's assets and pay the pensions and lump sum benefits.

Workplace Personal Pensions (Group Personal Pensions)- A group personal pension plan is a collection of personal pension plans provided by an employer for its employees.

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