CUSP CENTRE FOR THE UNDERSTANDING OF SUSTAINABLE PROSPERITY

World Future Council

Should we strengthen financial institutions' fiduciary duty?

Report on a roundtable for industry professionals

October 2017

Introduction

The need for the investment industry to help produce a sustainable economy and a cohesive society is well understood and much discussed. There have been some successes, and a number of official initiatives but as yet our environmental and social problems are as acute as ever. Can we clarify or redefine fiduciary duty in ways that would help, while protecting beneficiaries' long-term financial interests and avoiding excessive regulatory burden?

Some would simply say 'no' and argue that the current state of the law as clarified by the Law Commission in 2014 is adequate: it just needs repeated communication. However, there are reasons for thinking that some changes are needed. A roundtable to discuss this was held on 3 October 2017 at Aviva Investors and attended by three pension fund trustees or managers, five investment managers, six specialist lawyers, one management consultant, three academics and representatives of seven specialist NGOs.

Briefing on the Issues

The state of the law

The following are extracts from the Law Commission 2014 report on the duties of trustees.

- Trustees should take account of financially material risks.[1] When investing in equities over the long-term, the risks will include risks to the long-term sustainability of a company's performance. These may arise from a wide range of factors, including poor governance or environmental degradation, or the risks to a company's reputation arising from the way it treats its customers, suppliers or employees.[2]

[1] "Is It Always About the Money? Pension trustees' duties when setting an investment strategy: Guidance from the Law Commission" (2014). Para 1.20

[2] Ibid.Para1.16

- It is for trustees' discretion, acting on proper advice, to evaluate which risks are material and how to take them into account.[3] Trustees should consider, in discussion with their advisers and investment managers, how to assess risks. This includes risks to a company's long-term sustainability.[4]
- In general, non-financial factors [as opposed to the financial factors discussed in the last two paragraphs] may be taken into account if two tests are met: (1) trustees should have good reason to think that scheme members would share the concern; and (2) the decision should not involve a risk of significant financial detriment to the fund.[5]

The Pensions Regulator has since made explicit that where trustees "think environmental, social and governance (ESG) factors or ethical issues are financially material, [they] should take these into account".[6] But it is for trustees to decide whether or not the factors are material.

In addition, UNPRI (United Nations Principles for Responsible Investment) notes that in the UK and other jurisdictions, whether or not trustees have performed their duties is not to be judged only on the basis of outcomes, but on whether they have "applied an appropriate degree of diligence in their good-faith pursuit of beneficiaries' interests". [7]

Advice to trustees

Trustees are not getting the advice they need to assess what level of long-term risk the companies in their portfolios are exposed to, and thus the priority they should give to ESG factors. In part this may be because they cannot assess the quality of the advice they do get from consultants and fiduciary managers.

Although the Pensions Regulator advises trustees that they should understand the drivers of returns and risks[8], as things stand it would be difficult to show that their failure to procure the kind of advice needed constitutes a breach of fiduciary duty, a failure to apply "an appropriate degree of diligence": they are operating within established conventions, and the law does not define "an appropriate degree" or stipulate how to assess risks.[9]

However, given that fiduciary duty is about process, a focus on procuring the right advice on the implications of ESG factors on long term financial outcomes could be helpful.

Active Ownership

In the words of UNPRI "The current law does not contain an explicit duty to engage with, or to exercise share- holder rights in respect of, investee companies"[10] and so corporate engagement on behalf of funds remains patchy. This is particular important for broadly diversified investors and passive investors, who have limited scope to use stock selection to exercise influence or to diversify from generalised risk. Trustees are not normally in a position to engage themselves but are in principle able to instruct their asset managers.

A related concern is that these rights are not exercised in line with beneficiaries' priorities. It has been argued that trustees should establish these priorities before mandating asset managers to engage with investee companies in this or that way (to be discussed alongside consultation on non-financial factors—see next section.)

[3] IbidPara1.20
[4] IbidPara1.22
[5] IbidPara1.25
[6] The Pensions Regulator "Investment guidance for defined benefit pension schemes" (2017)
[7] UNPRI "Fiduciary Duty in the 21st Century" (2015)
[8] "You should understand the expected economic and market drivers of return that underlie your investment strategy and what may cause returns to be different from expected.....You need to understand the risks associated with your investment strategy" The Pensions Regulator (2017) op cit.
[9] "One interviewee cited climate change as an example, noting that beneficiaries would find it very difficult to challenge trustees' decision not to take climate change into account if the trustees had reviewed the evidence, taken advice from their investment consultant and deemed there to be no associated risk to the portfolio"– UN- PRI (2015) op cit.
[10] "This can be contrasted with the regulatory position in the US and Canada, where the equivalent securities and pensions regulators have asserted that shareholder rights are assets of the pension scheme to be used and monitored by fiduciaries in the best interests of beneficiaries." UNPRI "Fiduciary Duty in the 21st Century Roadm- ap" (2016).

‘Non-financial’ factors

A third issue arises from the Law Commission’s categorisation into financial and non-financial factors. Trustees may treat ESG factors as ‘financial’ in some cases, for example exposure to climate change regulatory risk, while considering other, ‘non-financial’ factors as matters of ethical taste. However, there is a sub-set of ‘non-financial’ factors which can be expected to affect the material interests of beneficiaries over the long term, even if not through the portfolio value.

For this reason, the EU High-level Expert Group on Sustainable Finance’s has recommended in its draft report that “Fiduciaries should throughout their decision-making process consider the broad range of long-term interests of their beneficiaries. In doing so, it should be made clear to financial actors that the long-term interests of beneficiaries include not despoiling the planet and exploiting their fellow human beings.”[11]

It has also been suggested that trustees should have a duty to consult beneficiaries on the non-financial factors they take into account, providing sufficient information to enable beneficiaries to give ‘informed consent.’[12]

Complementary measures

Trustees are constrained, and simply increasing their duties may not achieve the changes needed. Complementary measures may be needed, for example a requirement on investment consultants and asset managers to meet standards for advice and corporate engagement, or consolidation in the pensions industry, or other measures designed to induce culture change.

Report on the Event

After an initial introduction from Tim Jackson and Charles Seaford of CUSP, there were three short contributions from attendees. Will Martindale and David Pitt Watson provided useful histories of how the debate had move on over the last 10 years: the agenda of the meeting would have been inconceivable until recently. David Roach then helpfully set out the way in which the behaviour change needed for investors to become a force for better environmental and social outcomes depends on normative change. Fiduciary duty is one tool that can be used to help bring about this normative change.

Discussion of the issues

On advice to trustees, the existing obligation to take advice could be clarified by the Law Commission or the Pensions Regulator since at the moment many trustees do not have an understanding of what is needed.

Investment Consultants should have a complementary duty to provide appropriate advice and the current review of the industry could make recommendations along these lines.

On active ownership, existing trustee obligations could be clarified but the main obligation should lie with asset managers (who actually do the engagement). This obligation should include responding to the concerns of their clients (and, indirectly, of final beneficiaries).

Several issues connected with ‘non-financial’ factors were discussed:

ESG factors are of three types and the implications of fiduciary duty differ depending on the type:

- ESG factors that are material to valuation and where doing the right thing is rewarded by the market (i.e. the direction of materiality is positive)
- ESG factors that are immaterial either way, and
- ESG factors that are material to valuation but where doing the wrong thing is rewarded by the market (i.e. the direction of materiality is negative—think fossil fuel)

[11] High-level Expert Group on Sustainable Finance “Interim Report” (2017)

[12] ‘Informed consent ’implies (i) that the consent is freely given; (ii) that the giver has received an explanation of the risks and benefits of the decision being made; and (iii) that the giver has capacity to consent. So fiduciaries would have a duty to provide information about the factors that they consider in making investment decisions, including the likely effect on financial performance.

There needs to be more widespread understanding of the ESG factors that fall into the first category—i.e. where the direction of materiality is positive.

There should be a duty to consider the wider financial interests of beneficiaries, i.e. interests that go beyond the value of the portfolio. This is as per the draft recommendation from the EU High-level Expert Group on Sustainable Finance.

There should more widespread consultation with beneficiaries about investment strategy, which tends to result in greater focus on ESG issues, and perhaps a duty to consult beneficiaries on how to treat ESG factors.

There was some discussion of terminology: the distinctions between financial and non-financial, and between material and non-material. While some participants argued for greater clarity on these, others warned against being overly distracted by the "materiality trap". Opinions also differed on whether ESG was itself a useful term. The conclusion was that whatever its failings, the term has been a useful hook for advancing the agenda and may remain such in the immediate future.

How is fiduciary duty to have effect? It will work by influencing norms—but opinions differed as to whether it can do this without powerful sanctions. The Stewardship Code has not had the desired normative effect. The problem is that sanctions can deter individuals from becoming trustees; the resolution of the dilemma may be stronger duties (and associated sanctions) for asset managers and investment consultants. This would be desirable in any case.

Any strengthening of fiduciary duty should be complemented by technical work on the long-term sustainability risks (e.g. climate risk) that underlie ESG factors, better metrics for ESG factors, development of standards, education of trustees (possibly involving modifying the Pensions Regulator training tool kit) and better, proactive communication with beneficiaries.

Next steps

Some of the conclusions from the roundtable could be fed directly into existing processes:

- The recommendation that there should be duties to consider the wider financial interests of beneficiaries, and to consult with beneficiaries could be fed into the EU High-level Expert Group on Sustainable Finance, and the UK Green Finance Taskforce. Individuals and organisations represented in the room were members of these fora.
- The Government was also consulting on the Law Commission's recommendations that changes are made to the law to strengthen consideration of ESG and beneficiaries' ethical concerns and those attending the meeting could respond to this.

Other actionable points emerged but required further work before submission to policy makers:

- The need for further clarification by the Law Commission and/or the Pensions Regulator of the different types of factor that can or should be considered
- The need for further clarification by the Law Commission and/or the Pensions regulator of what advice is appropriate for trustees to take in different circumstances, and to provide appropriate training/ education
- The need to articulate more clearly and forcefully the duties owed by asset managers
- The need to articulate more clearly and forcefully the duties owed by investment consultants (The current review of the investment consultancy industry is a useful channel for this work)
- Development of a clear view on the role and nature of any sanctions backing up these duties
- Development of a specification for a revised Pensions Regulator training toolkit
- Development of a new duty to consult beneficiaries (and perhaps retail clients more generally), taking into account the difficulties trustees have as things stand.