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Investment for a sustainable and inclusive economy
—Proposed changes to UK law

World Future Council

CUSP CENTRE FOR THE UNDERSTANDING OF SUSTAINABLE PROSPERITY

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Executive summary

The problem

There are potential reforms to the investment industry that would make it more likely that capitalism delivers sustainable and inclusive prosperity. They would do so by making it easier for shareholders to put pressure on company managers to take account of the public good[1] and to adopt a long-term focus when making business decisions. The public good includes such things as a cohesive society, increased prosperity and environmental stability, all of which are likely to help **increase portfolio values over the long-term as well as advance the other interests of shareholders and those saving for or receiving a pension ('savers')**. The reforms would also help advance the objectives set out in both the Conservative and Labour manifestos for the 2017 election. They are in line with some of the more progressive thinking in the investment industry.

At the moment, company managers often fail to take account of the public good even when doing so would be in the interest of savers, and they sometimes sacrifice long-term financial success in order to achieve short-term financial success (for example by cutting the R&D budget). This is largely because of the nature of their incentives, which are often linked to profit performance and the share price. Investment intermediaries such as asset managers already have the tools to change these incentives and make them more aligned with the interests of the savers on whose

[1] By the 'public good' we mean the wellbeing of the economy and society as a whole.

behalf they work. However, they themselves lack incentives to use these tools. This is largely because savers have no power.

Proposed solution

We propose increasing savers' power by specifying in more detail the nature of investment intermediaries' fiduciary duty[2] to serve their best interests. This duty already exists, but despite clarification from the Law Commission in 2014, what constitutes 'best interests' is still too vague to drive change. Custom and practice prevails. If, however, activist saver groups can litigate when the duty is neglected—much more likely if it is more precisely specified—then a new, strong incentive for change is created.

To achieve this, we recommend that Parliament makes it explicit that trustees and other investment intermediaries have a duty to their savers to exercise such influence as they have to advance (a) the long-term financial success of investee companies, (b) those aspects of the public good likely to enhance portfolio value, (c) after consultation with their savers, other aspects of the public good that are clearly in their interests, and (d) any ethical objectives savers may have. Parliament should also make explicit that this will require intermediaries to act as 'stewards', that is to engage with companies and exercise voting rights. Parliament should also make explicit the kinds of procedure needed to decide which aspect of the public good are to be advanced.

How this goes beyond recent regulatory changes

The Department for Work and Pensions has recently laid new regulations before Parliament designed to improve pension fund trustees' accountability by creating various obligations to *report* to savers. This is progress, but given the inertia in the industry, these are unlikely to change intermediary behaviour to anything like the degree needed. Also, they ignore the contribution that companies can make to aspects of the public good that in turn contribute to portfolio value and other drivers of savers' material wellbeing. And they don't take full account of the preference many savers have for an ethical form of capitalism. It is at these broader levels that the opportunity to use the investment system to help capitalism deliver sustainable and inclusive prosperity mainly exists.

Complementary changes needed

To respond to this opportunity, to perform their newly specified duty, intermediaries will need new kinds of information and new capabilities. Much work is being done on information, but the problem is lack of common standards, and government should facilitate these. It should also encourage provision and take up of suitable training. In addition, asset owners will be better equipped to respond to the new duty, and the pressure from savers it creates, if they are large enough to do what is needed, and if they have saver representation in their governance structure. Government should continue to encourage consolidation and strengthen asset owner governance rules. Finally, regulatory barriers to the new duty should be removed, and any necessary changes to regulator mandates made.

The message for politicians

Delivering an effective investment industry has been largely delegated by politicians to regulatory bodies, on the assumption that the measures needed have little relevance to wider social and economic issues. The argument of this paper implies that this assumption is false, and that therefore politicians could usefully consider what may have been seen as purely technocratic issues.

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[2] And where necessary stipulating that intermediaries are fiduciaries

1
Introduction

This paper was prepared by Charles Seaford of the World Future Council as the result of an inquiry into sustainability and investment. It is part of a portfolio of activities within the Centre for the Understanding of Sustainable Prosperity and funded by the Economic and Social Research Council. It draws on other reports and papers (see bibliography), as well as ongoing work at CUSP over the last two and a half years, involving three roundtables and 33 one-to-one discussions with industry practitioners and activists.

There are reforms to the investment industry which could advance sustainable prosperity and could advance objectives in both main parties' 2017 manifestos. They would help make capitalism a system that "works for everyone" (Conservative) and that "works for all" (Labour). This paper sets out what those reforms are, how they can be implemented by the Government, and why they would have the impact described. It is only about the equity market—it does not cover bonds or banking—and it is only about the quality of investment intermediation, not its cost: the latter raises a quite separate set of issues. Much of the paper is about pension funds; the paper does not cover issues specific to defined benefit schemes and some refinement may be needed to cover these fully.

The paper is structured as follows. Following this introduction, section 2 sets out the objectives of the reforms. Section 3 sets out how the system works now and the limits of recent and pending reforms, section 4 sets out our proposals for changing investment intermediaries' incentives by strengthening their fiduciary duties and section 5 sets out proposals for equipping intermediaries to act on these incentives, largely a synthesis of others' recommendations. There are two annexes, one summarising relevant section of the two main parties' manifestos, and the other providing additional evidence for facts and arguments in the main body of the report. References to relevant sections of this annex are included in the footnotes to the main report.

A note on terminology. We use the term 'savers' to refer to those on whose behalf various kind of **investment intermediary invest, advise or** transact. Savers include those saving for a pension, pensioners, and anyone else with investment in some form of collective vehicle.

Intermediaries include:

- **Asset managers**, who buy and sell shares and engage with companies; these may be 'active', and select which shares to buy and sell themselves, or 'passive', and base their selection on the composition of an index (for example the FTSE 100 index)
- **Asset owners**, that is the pension funds or other collective investment vehicles which commission asset managers (and sometimes have their own in-house asset managers).

We do not discuss a third type of intermediary—**financial advisors** and investment platforms that advise on, or provide access to, asset managers and asset owners. However much of what we say about asset owners also applies to financial advisors, mutatis mutandis.

We use the term '**company managers**' to refer to the directors of investee companies.

2
The objectives of the proposed reforms

2.1 | The two outcomes we should work towards and why

We have identified two outcomes which investment intermediaries could and should aim for. They would advance the interests of long-term savers, advance both parties' manifesto objectives (see Annex 1), and advance sustainable and inclusive prosperity:

- The long-term financial success of investee companies
- Certain aspects of the public good[3]

These are in addition to any ethical objectives that savers may have and wish their intermediaries to act on. The rest of this section sets out why investment intermediaries should target these outcomes. The various routes between good decisions by company managers and good results for savers are set out in figure 1.

The long-term, as opposed to short-term, financial success of investee companies is in the interests of long-term savers, such as those saving for a pension. The common-sense reason for this is that long-term savers need long-term returns. It is true that the long-term is made up of many short-terms, and as an investor you can make money over the long-term by repeatedly making it over the short-term. However, this is only more effective than benefiting from the long-term success of investee companies if you regularly 'beat the market,'[4] and by definition the typical saver or asset manager cannot do this. The long and the short of it is: the common-sense reason is valid.[5] In addition, companies that pursue the strategies needed for long-term financial success are more likely to contribute to the public good, for example by investing in people and innovation, and this, as we will see, is also in the interest of savers.

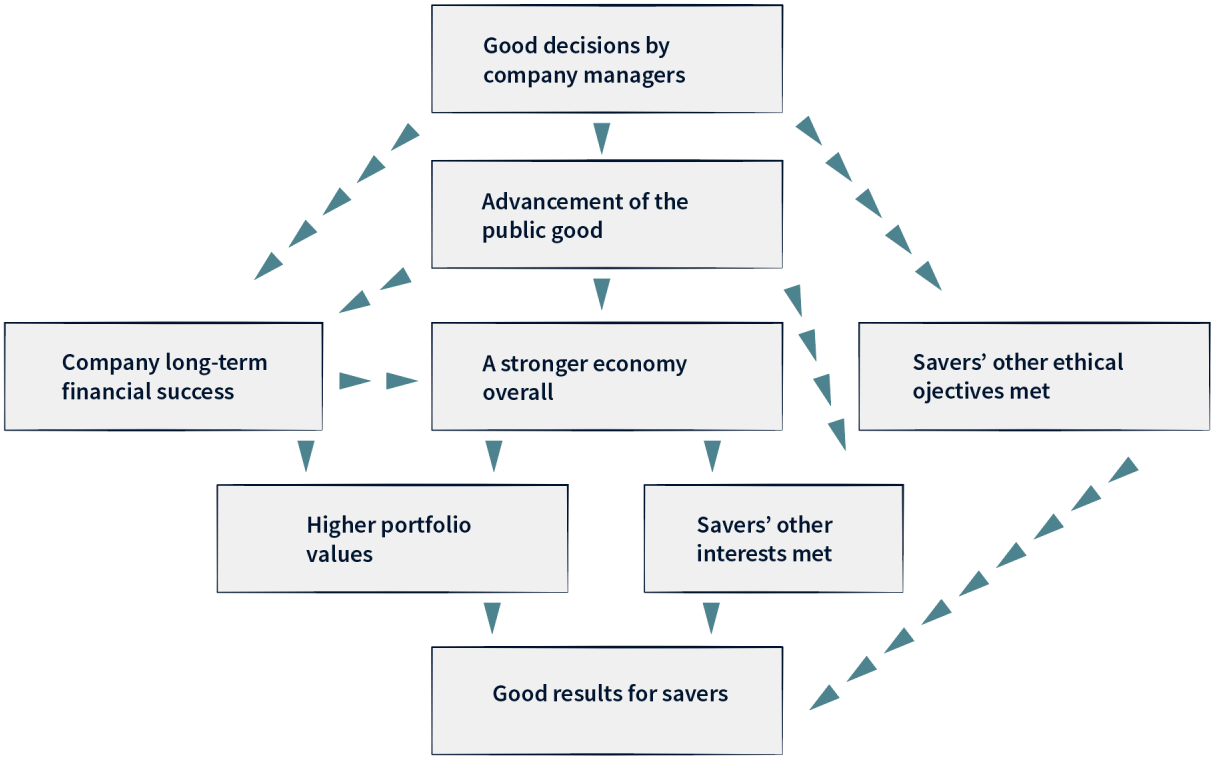

Figure 1 | Good decisions and good results

[3] Or the 'common good' to use the Conservative terminology
[4] As Warren Buffett has put it at the 2016 Berkshire Hathaway General Meeting: "any attempts to pick the times to buy or sell are a mistake for 99% of the population."
[5] This does not in itself show that investment intermediaries should act to advance the long-term financial success of investee companies. If you can pick those companies likely to be successful in the long-term it could be more efficient just to invest in such companies and take no action. We return to why the latter is not an adequate strategy in section 2.2

Change is needed. At the moment some company managers sacrifice long-term financial success in order to achieve short-term financial success (for example by cutting the R&D budget).[6]

Long-term savers also have an interest in aspects of the public good. This includes such things as a cohesive society, increased prosperity and environmental stability, and other things that contribute to the wellbeing of the economy and society as a whole.

This is for three reasons. Firstly, companies that pursue the public good tend to do well financially over the long-term. Secondly, certain aspects of the public good will increase the overall value of portfolios. Thirdly, savers will have an interest in certain aspects of the public good as taxpayers, citizens and workers. In addition to their interest in the public good, some savers may prefer investee companies to advance the public good for ethical reasons.[7]

Companies that pursue the public good tend to do well financially, but mainly over the long-term.[8] Much of the evidence is framed in terms of the impact of taking 'environmental, social and governance (ESG)' issues seriously on long-term profitability.[9] 'Taking ESG seriously' may mean, among other things, being concerned with the interests of all stakeholders (as referred to in both parties' manifestos) and being alert to the regulatory and other risks associated with carbon intensive and other environmentally damaging activity, and as a result helping to advance the shift to a sustainable, low carbon economy.

In addition to this long-term impact, there may be a short-term impact for companies with consumer facing brands, because of the reputational effects. For other companies, taking ESG seriously may mean sacrificing short-term profits for the sake of long-term profits, meaning that those with a short-term focus will probably not do so.

Long-term savers also have a financial interest in the public good over and above their interest in the positive impact of ESG policies on the companies that pursue them. Most obviously, climate change could have a devastating effect on the economy, and therefore on portfolio values, and over-use of natural resources and reduced bio-diversity could have a similar effect. This is likely to outweigh any positive impact on portfolio value of individual companies adopting environmentally damaging policies. More generally, savers' interest in the public good could require companies to adopt environmentally friendly policies even when these reduce profits for that particular company, or at any rate seem to management to be a distraction from establishing competitive advantage and maximising profits. (This point is sometimes obscured by conflating the systemic and therefore undiversifiable risks associated with climate change and other environmental degradation, which can only be mitigated by reducing the impacts of these things, and the sector-specific or company specific risks, which can be mitigated by divestment. Savers' interest in the public good arises because of the systemic, undiversifiable risks).

This interest in the public good is in an inclusive economy as well as in environmental sustainability. In the short-term, a more equal, i.e. more inclusive, economy tends to result in increased demand and less need for tax funded redistribution, in principle good for business and thus portfolio values. An inclusive economy also leads to higher levels of trust,[10] which has been shown to have a positive economic impact, partly by making some regulation unnecessary, but more generally by increasing people's willingness to co-operate.[11] More dramatically, the low levels of trust caused by economic exclusion can lead to sharp and sometimes economically damaging political change, as we saw with the Brexit referendum.[12] On a more positive note, a more inclusive economy will be associated with a stronger and above all more flexible skill base,

[6] See Annex 2, section 1.3
[7] See Annex 2, section 3.2
[8] See Annex 2, section 1.2
[9] In the investment world, the term 'ESG' is sometimes confined to those factors which can be demonstrated to have an impact on the financial performance of the portfolio in this way, and for the most part via company level impacts only. In addition, most reports focus on environmental sustainability rather than social or economic factors, but the same rationale and principles apply to other aspects of the public good.
[10] See Annex 2, section 2.1
[11] See Annex 2, section 2.2
[12] See Annex 2, section 2.3

and there is widespread agreement that this is good for both prosperity and profits.[13]

This argument is in line with some of the more advanced recent thinking within the investment industry. For example, in January 2018, Hiromichi Mizuno, the Managing Director of the Japanese Government Pension Investment Fund—the world's largest—remarked that the fund's returns were overwhelmingly dependent on returns in the market as a whole, and thus on the level of systemic risks which affect the real-world economy. The scope for increasing the fund's returns by picking this or that company to invest in was very small. For this reason, its core focus was on improving market performance overall, which it does through stewardship.[14] Also in January 2018, Larry Fink, Chief Executive of Blackrock, the world's largest asset manager, wrote to investee companies, pushing for long-term socially aware strategies.[15] And again in January 2018, major UK asset manager Hermes defined its purpose as including "a duty to deliver holistic returns—outcomes for our clients that go far beyond the financial and consider the impact our decisions have on society, the environment and the wider world."[16]

In addition to their interest as shareholders, savers are highly likely to have an interest as taxpayers, citizens and workers in these things. Prosperity, stability and an absence of environmental shocks will increase portfolio values, but will also allow tax rates to be lower than they otherwise would be and/or public services better. Similarly, savers have an interest in a business culture which encourages companies not to avoid tax in an aggressive way since they may well lose more as taxpayers than they gain as shareholders from such practices.[17] More broadly, savers have an interest as citizens in a cohesive society, balanced growth and a stable environment—no-one will benefit from runaway climate change. Many savers will also benefit directly or indirectly from labour market norms that encourage decent treatment of workers and investment in skills—after all 44% of the workforce are saving for a pension.[18]

Advancing savers' interests in these ways is a matter for the investment industry. It is sometimes argued that it is for government to regulate for the public good, but government is not perfect, and may need to be influenced by investment intermediaries when this is in the interest of savers. Nor is regulation perfect, and it is likely to be more effective if business is under pressure from its owners to work with government, rather than against it. At the same time, it will sometimes be in the interest of savers for there to be a genuine partnership between business and government based on shared goals, rather than a marriage of convenience based on regulation and fiscal incentives. Improving workforce skills, for example, requires just such a partnership, while using fiscal incentives on their own can be a very inefficient way of stimulating the necessary investment, whether in skills, R&D or underdeveloped regions. Similarly, climate change cannot be solved purely by regulation and fiscal incentives. Experience shows that aggressive tax avoidance is very difficult to prevent using regulation.

The importance of these interests will be different for different shareholders—but that doesn't mean they should be ignored. Rather it suggests that shareholders themselves should decide how, if at all, the directors of the companies they own should take account of the public good.

The role of investment intermediaries can be illustrated in a schematic example. Imagine a group of investors with just two holdings, one in a factory by a river and another in a hotel by the same river downstream. The factory is more profitable if it pollutes the river, but the portfolio as a whole is more profitable if it does not. The investors' asset manager may first lobby government to regulate against pollution. If it is successful, it can then encourage the factory managers not to try and subvert the regulation. If it is not successful, it can still put pressure on the

[13] See Annex 2, section 2.4
[14] Mizuno 2018 quoted in Hawley et al 2018
[15] Fink 2018
[16] Hermes 2018
[17] See Annex 2, section 3.1
[18] http://www.pensionspolicyinstitute.org.uk/pension-facts/pension-facts-tables/private-pensions-table-13

factory management not to pollute. In this example the investors' financial interests are not identical with those of the individual companies in which they own shares.

Change is needed. At the moment company managers do not pursue the public good, except to the extent that it increases profits (and they may not do that if the increase in profits is only in the long-term). This can damage savers' interests– as well of course as the British economy and society more broadly.

2.2 | The need for asset managers to change company managers' incentives

Company managers' incentives encourage the pursuit of profit over the short-term, sometimes at the expense of profit over the long-term. These incentives are often linked to share prices and share prices are more influenced by 'traders', that is those who try to anticipate other market participants' decisions when deciding to buy or sell a share, than they are by 'investors', that is those who try to understand companies' prospects (terms defined by John Kay in his 2012 report for the Government on short-termism).[19][20] This focus on other market participants increases the influence of market norms and thus of easily understood and widely accepted performance metrics such as quarterly earnings figures. These then become the basis for trading decisions, and thus the share price, and thus managerial incentives. It is not that managers do nothing to achieve long-term financial success, just that these incentives sometimes lead them to sacrifice it in favour of short-term success.

Even when company managers focus on the long-term, they are only incentivised to pursue the public good to the extent that it increases profit. There are no incentives to pursue the public good if it only benefits the economy as a whole. So, for example, they will take into account any regulatory and/or reputational risks associated with bad practice, and they will take into account the effect on customer service or product quality of poor working conditions and wages. However they may not engage in the kind of constructive dialogue with government needed to develop skills in a relatively deprived area, or to get obesity down.[21] It might be better for diversified savers were the managers of all their investee companies to pursue the public good in this and other ways (as argued above), but there are no incentives for them to do so.

Asset managers and asset owners could and therefore should address the incentives problem. They already have the tools: approval of executive incentive schemes,[22] informal pressure and support, including threat of divestment, and approval of director appointments. Note that these are all forms of 'stewardship' rather than 'investment': most asset managers and pension funds already have a long-term investment strategy, and more of them doing so would make little material difference to the relative influence of traders and investors on share prices, and therefore on company managers' incentives.

Action by asset managers and asset owners is needed in addition to any direct action by government. While the problems could, in principle, be dealt with directly by government regulation of incentive schemes, and steps to reduce the influence of short-term trading on share prices, any such intervention is likely to be more effective if accompanied by action by asset managers and asset owners. In any case there are arguments for and against such intervention and the Labour and Conservative parties are likely to adopt different policies. In the absence of government intervention, or if it proves difficult, action by asset managers and asset owners will be essential. They should take this action since, as already argued, it would be in the interest of the savers they represent.

This action complements rather than replaces effective corporate governance. The Government has already taken action to strengthen the latter through the Corporate Governance Code and will be increasing directors' obligations to report against their duties to stakeholders. We believe that further

[19] Kay 2012

[20] See Annex 2, section 1.4

[21] See Annex 2, section 1.2

[22] This tool will be strengthened in 2019 with the implementation of the Shareholder Rights Directive II

changes to corporate governance rules, such as the shareholder committees proposed by Conservative MP Chris Philp,[23] or worker representation on boards as proposed by the Labour Party and previously by Theresa May, could make action by investment intermediaries of the kind we propose more effective, and suggest that such reforms complement the proposals in this paper. [24]

Asset managers and asset owners do not use the tools available to them, primarily because they themselves lack incentives to do so. Asset managers are not incentivised by their clients, the asset owners, and the asset owners' clients—ordinary savers—generally lack the interest, knowledge or power to apply any pressure for the necessary action. Perceived, and perhaps actual, legal constraints have reinforced rather than corrected this lack of incentive.[25]

Hence the thrust of our recommendation, set out and justified in the next two sections: government should change the incentives of asset managers and asset owners so that they are aligned with the interests of savers. There are already pockets of good practice, and our recommendations are in line with some of the more advanced thinking in the industry. However, while stewardship initiatives have had some successes on specific issues,[26] good practice has not reached anything like the critical mass needed to change company manager incentives.

Even if asset managers and asset owners had incentives to act, many of them are not equipped to take effective action. They need new forms of information and the competence and power to use them; they do not have these, partly because they lack incentives to acquire them, partly because as yet there has been no standardisation, making use of what information there is relatively difficult, and partly because of industry structures and conventions. Section 5 deals with these issues.

[23] Philp 2016

[24] See also proposals to restrict mergers (Kay 2012), to make incentives more closely related to long-term financial success (Kay 2012), that directors should act in the interest of stakeholders (IPPR 2017, EU High Level Expert Group on Sustainable Finance 2018), for worker representation on boards (IPPR 2017), for corporate governance codes that promote sustainable development (Aviva 2014) and social impact, using the Sustainable Development Goals (Corley 2017), and for mandatory climate and Sustainable Development Goal strategies (EU High Level Expert Group 2018).

[25] See Annex 2, section 5.2

[26] See Annex 2, section 3.3

3

Intermediaries' incentives—where we are now

3.1 | How the system works

Asset owners currently incentivise active asset managers to focus on short-term share price movements. Asset owners, advised by investment consultants, often use quite sophisticated methods of assessing asset managers on first appointment, but may then base re-appointment decisions on quarterly portfolio valuations. This means that active asset managers are incentivised to maximise these valuations, and thus to pay close attention to the short-term movement in share prices upon which these valuations depend. It is not that they ignore long-term factors: many sell themselves on their ability to predict long-term performance, and initial appointments will often be based on their ability to do so. But once appointed, the dominant external pressure is for short-term performance.[27]

As a result, active asset managers rarely challenge short-term profit maximisation when engaging with companies. They often engage with investee companies—their initial appointment may depend on this—but they do not attempt to so change company manager incentives that long-term considerations can be relied on to trump short-term considerations. This would require concerted action by a significant number of asset managers, and in the absence of specific instructions from their clients, i.e. the asset owners, the asset managers lack the necessary incentive to make the very considerable effort required. Indeed, there is even a danger that changing company managers' incentives or dismissing directors would lower the share price and thus the portfolio valuation and thus the chances of reappointment.

Even for asset managers pursuing a long-term strategy, current incentive structures make it rational to let company managers take short-termist decisions. Thus, as we noted in a report on a CUSP roundtable for City professionals in April 2016,

- It is rational for a long-termist investor to let a company it owns shares in take a 'short-term' decision that will boost its share price. For it can then sell its shares and invest in a second company pursuing a long-term strategy. That way it 'beats the market' twice —when it takes its profit, and when it enjoys the market beating returns of the second company.[28]

While this may be rational for an asset manager competing on its ability to beat the market, there are two problems for savers when most asset managers pursue the strategy. The first is that it is difficult to execute the strategy successfully and consistently—attempts to beat the market this way often fail (and in aggregate are bound to fail). The second is it creates incentives for company managers to pursue strategies that are damaging to the economy (as argued in section 2) and therefore damaging to shareholders' interests at the aggregate level.

Two solutions are possible to this problem: reduced liquidity or changed incentives. We are focusing on changed incentives. Reduced liquidity means shareholders are locked in to the companies and therefore cannot sell in the way described in the previous paragraph: their only way to improve financial performance is to change management behaviour. While passive investors already suffer reduced liquidity (see below), for active investors it can only be achieved either through very large holdings which are difficult to sell,[29] or through a heavy transaction tax. We think there is a debate to be had as to whether such changes would be more or less effective and achievable than changed incentives, and whether or not they would generally be in savers' interests, but in line with most current

[27] See Annex 2, section 4.1. We are not suggesting that underperformance should be ignored indefinitely. Consistent under-performance is a better indicator of future performance than consistent over-performance —see Annex 2, section 5.3. As the chief investment officer of one of the most sophisticated asset owners put it to us, you can ignore underperformance once, perhaps twice, but it takes quite a bit of nerve to ignore underperformance for several quarters in a row, however good at long-term investment you believe the asset management team may be.

[28] Seaford 2016

[29] Very big funds like the Japanese Government Pension Fund and Blackrock which, as we saw in section 2.1 are leading on stewardship, tend to find it difficult to sell their stakes because they are so large —and also tend to have investments across the market, making them more like passive managers than the classic stock picking active manager.

discussion, we are focussing on changed incentives.

The approach of the funds referred to in section 2.1, with its emphasis on stewardship and encouraging company managers to focus on the public good is not the norm. According to specialist NGO ShareAction there are "pockets of very strong responsible investment practice."[30] However, these pockets have not reached the critical mass needed. Fink's example may encourage other asset managers to follow suit, but the structural constraints just referred to will still apply, particularly to smaller asset managers. In any case he has not been attempting to change radically company manager incentives so that the long-term always trumps the short-term or so that the public good becomes one of their objectives.

In theory, passive asset managers are not constrained in the same way, but they sometimes behave as if they were. Passive managers are not evaluated on the basis of quarterly valuations so are not constrained by fear of share price movements. In addition, because they cannot simply sell shares in companies with what they think are risky strategies, they have an incentive to engage with these companies' managements. Legal and General Investment Management, one of the largest passive managers, does a lot of engagement for this reason. However, the fact remains that passive managers have not changed company manager incentives or adopted aggressive 'long-termist' positions any more than active managers have, presumably because they feel that such action will be ineffective given prevailing market norms.

Indeed, some passive managers do not engage with companies at all because asset owners do not require them to do so. This is because they are often selected on the basis of costs (if they are basing their product on a standard index such as the FTSE 100 their service is a commodity) and therefore cut out engagement as an unnecessary expense. This is a classic 'collective action' problem: it will benefit all savers if all passive managers engage effectively with companies, but it may benefit the clients of any given manager if that manager does not engage but relies on the activities of others and thereby reduces its costs.[31] The solution, both to this problem and to the market norms problem described in the previous paragraph, is for asset owners to get together and ask the managers to act collectively and share the costs, but they do not do this.

In short, asset managers fail to change company manager incentives because of the instructions (mandates) they receive from asset owners and the way they are subsequently assessed.

Asset owners behave as they do, largely because of their incentives. Asset owners use quarterly portfolio valuations when assessing asset manager performance, not because it is the best method—evidence shows that it is a very poor method[32]- but because it is simple, it has become accepted as normal, and no easy to use, cheap alternative has been developed. This means they can justify it to their customers and to regulators. They are not incentivised to optimise savers' interests but to avoid risk and conform with conventional norms of behaviour—in economic jargon they 'satisfice' rather than 'maximise'.[33] Their customers are savers, but these customers generally have difficulty judging whether asset owners are doing a good job (and in any case, if the asset owner is a company pension scheme the saver will normally have no choice) and so there is minimal market pressure for better assessment of asset managers or for engagement with companies.[34]

It is true that asset owners already have a duty to act in the best interests of savers. However, what constitutes acting in this way is loosely defined, making it difficult to argue that existing custom and practice is a breach of that duty. In other words, the duty constrains egregious behaviour, but it is not a lever for change. Indeed, in the recent past this duty has even been cited as a reason for prioritising short-term profits at the expense of ESG factors! This continuing misunderstanding, incidentally, is good evidence of the inertia in the industry since a definitive

[30] ShareAction 2017

[31] See Annex 2, section 4.2

[32] See Annex 2, section 5.3

[33] See Annex 2, sections 5.1 to 5.4

[34] See Annex 2, section 5.5

correction of the misunderstanding was first published in 2005 by leading law firm Freshfields Bruckhaus Deringer.[35]

3.2 | Work by the Law Commission and the DWP on asset owners' incentives

In recent years attempts to change asset owners' incentives have focused on clarifying fiduciary duty,[36] and on associated regulatory change. The Law Commission published a clarification of fiduciary duty in 2014. This distinguished between those factors trustees were *obliged* to consider when developing an investment strategy, and those that they *may* consider under certain circumstances. Broadly, they are *obliged* to consider financially material factors, that is factors which they believe may materially affect the value of the portfolio, and these can include ESG factors (though whether they do is a decision for the trustees themselves), and they may consider other factors provided they have reason to believe most members wish this, and that there will be no loss of portfolio value as a result (although the latter constraint can be overridden if there is a specific mandate from members). These obligations relate to investment strategy: The Law Commission did not identify an obligation to engage with companies or exercise voting rights in order to maximise portfolio value. [37]

This, and guidance by The Pensions Regulator two years later,[38] is helping correct the misunderstanding that fiduciary duty requires trustees to adopt a narrow interpretation of financial factors, for example limiting them to those likely to have an impact in the short-term and excluding ESG factors.[39]

In September 2018, the DWP laid regulations before Parliament building on the Law Commission work, designed to create pressure for changed behaviour by pension fund trustees.[40] The regulations create a new obligation on trustees to publish how they will take into account financially material factors, including ESG factors such as climate change, and how they will engage with companies and exercise voting rights. The latter obligation complements an existing Financial Conduct Authority (FCA) regulation obliging intermediaries to disclose how they comply with the Financial Reporting Council (FRC)'s Stewardship Code (or if they don't what alternative approach they have adopted).[41] The draft regulations also contained an obligation on trustees to report how if at all they would take into account the views they believed their members held on the fund's investment principles, but this was dropped after consultation with the industry. Trustees must then report on the implementation of these policies. Presumably the thinking behind this is that the obligation to report will create pressure on trustees from peers and savers to change their behaviour and to pay more attention to ESG factors.

If savers are to exercise this pressure, it will help if they are more financially literate. Accordingly, there have been several recommendations in this area. These are public goods and so have to be provided, mandated or incentivised by government.[42]

3.3 | Why these changes are not enough

Clarification of fiduciary duty, greater transparency and financial literacy are all helpful—but are unlikely to be enough to drive change of the kind required. This will remain a market where, to put it bluntly, most people don't know what they are buying and hence where

[35] See Annex 2, sections 5.2 and 5.4

[36] Fiduciary duties are certain duties owed by a fiduciary but not by anyone else, and traditionally understood as negative (for example not to be disloyal) rather than positive (for example to promote the best interests of a beneficiary). A fiduciary is "someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence" (Lord Justice Millett quoted by the Law Commission 2014). Fiduciaries and professionals who are not fiduciaries may have other duties, such as a duty to exercise reasonable skill and care. Given that we are advocating a statutory definition of duties, the distinction between fiduciary duty and other duties, rooted as it is in case law, is immaterial. We will use the term fiduciary duty because we believe that the concept of loyalty on which it is based is useful, but on the assumption that any statute makes clear that investment intermediaries are fiduciaries and that the duties involved can be positive.

[37] See Annex 2, section 6.1

[38] The Pensions Regulator 2016

[39] See Annex 2, section 5.2

[40] See Annex 2, section 6.2

[41] FCA COBS Rule 2.2.3

[42] See Annex 2, section 5.5

there is considerable inertia. It seems implausible that publishing strategies and details of how strategies have been implemented on web-sites will drive major behavioural change. After all, comparable obligations already exist (as just cited) and have not led to significant change.

We have identified four gaps in the Law Commission clarification and the DWP draft regulations, which make change unlikely.

Firstly, the DWP regulations only stipulate that trustees must *publish* their policy on stewardship and how they then acted on this policy. They do not require trustees to actually engage or exercise voting rights; indeed, the DWP consultation document states explicitly that it will be acceptable to have a policy of 'no policy' and acceptable not to follow the wishes of scheme members on this question. Since, as already argued, it is stewardship rather than investment decisions that will change company manager incentives and behaviour, this is a fundamental gap.[43]

Secondly, the clarification and the regulations fail to make explicit that an investee company's contribution to the public good can be a 'financial factor' through its impact on overall portfolio value (except in so far as it affects the profits of that particular company). As already argued in section 2.1, portfolio level impacts may be positive even when individual company level impacts are negative or negligible. However, the Law Commission and the DWP fail to state that trustees should take account of such contributions in the absence of an impact on the value of the company itself. On the other hand, the Commission does refer to individual company level impacts, and the DWP consultation document does give examples of this latter kind of impact. To be fair neither body says contributions to the public good that only have an impact at portfolio level are not material—but since such impacts are rarely considered as things stand, failing to mention them is failing to change behaviour.[44]

Thirdly, the clarification and the regulations fail to stipulate a procedure for identifying financially material factors, i.e. those factors trustees are *obliged* to take into account. As we have seen, the existing law states that there is only an obligation to consider financially material factors while other factors *may* be considered under certain circumstances. This makes the decision as to whether a factor is financially material or not critical. The *procedure for reaching this decision* as well as the decision itself is left to the discretion of trustees (although they are now obliged to report on this).[45] While we agree that the substantive decision should be left to trustees—government or regulatory intervention at this level would be intrusive—leaving the procedure to trustees will do nothing to overcome inertia. It is very likely that any factor newly thought of as financial (such as advancing the public good) will be deemed immaterial by most trustees and their advisors, and perhaps the courts. It will be almost impossible for savers or their representatives to challenge such decisions. If we want change, mechanisms are needed to counter this inertia.

Fourthly, the DWP consultation is explicit that there will be no new obligation on trustees to consult members on non-financially material factors, or to act in their broader interests or on their ethical preferences. Acting on factors that do not have a material impact on portfolio value will continue to be at the discretion of trustees. Given the potential importance of these factors to savers' interests including their financial interests (for example through the impact of climate change), and the sincerity with which ethical views are held, this is a striking gap.

To create real pressure for change, the gaps just described need to be filled. In the next section we set out our proposals for doing so.

[43] Funds that have a controlling interest in a company are however obliged by their duty of care to exercise stewardship

[44] Note that 'taking account' in such a case would not lead to a decision to buy or sell shares in the company, since, ex hypothesis, there is no greater impact on the company than on any other company in the portfolio. It might lead to a decision to engage with the company —whether to support a positive contribution or discourage further negative contributions, in both cases the aim being to increase the financial value of the portfolio as a whole. It is also worth noting that such engagement will only be effective and have an impact on the portfolio value if it is widely practiced, but this should not reduce the obligation on each individual asset owner to take part in what is by its nature collective action.

[45] Fiduciary duty requires that trustees "take into account relevant considerations and ignore irrelevant considerations" when making this and other decisions—not perhaps an especially controversial requirement!

4

Our recommendations for reforming incentives

4.1 | Asset owners

We do not believe the gaps just described should be filled using detailed regulation. The history of financial sector regulation suggests that regulation designed to influence behaviour directly can be problematic: there has been a huge explosion of such regulation, much of which is ineffective or even counter-productive. This perhaps is why the DWP has been careful not specify what trustees should do, merely what they should report.

Instead, we agree with the UN PRI (Principles of Responsible Investment) and many others that the focus should continue to be on fiduciary duty.[46] This is potentially powerful because it allows a well-informed customer to sue if the duty has been breached and s/he has suffered as a result. While of course most customers are not well-informed and do not have the resources to sue, some do, and class actions are possible. Thus, specifying the nature of these duties can create external, customer-led pressure on the industry in a way that creating new reporting obligations cannot.

We therefore recommend that Parliament re-defines the nature of asset owners' fiduciary duty and instructs the Government to issue a set of guidelines outlining what this entails. Statutory change is needed: case law is far too slow and uncertain a method for responding to what are quite fundamental changes in the economy and society. Nor are the changes a matter of simply clarifying the law as it stands or developing regulations within existing primary legislation. (We return to the Law Commission's objections to statutory change below).

The new legislation would make explicit that advancing savers' best interests requires asset owners to:[47]

1. Exercise such influence as they have to maximise the long-term financial success of investee companies
2. Exercise such influence as they have to advance those aspects of the public good which will materially affect the financial value of the portfolio
3. Adopt robust procedures for deciding what will materially affect the financial value of the portfolio, including consulting with and reporting to savers
4. Consult savers on other factors potentially affecting their interests or on which they may have ethical preferences and act accordingly.

We summarise here the rationale for these and what the accompanying guidelines need to cover.

1. *Exercise such influence as they have to maximise the long-term financial success of investee companies*
2. *Exercise such influences as they have to advance those aspects of the public good which will materially affect the financial value of the portfolio*

This will fill the first two gaps in the Law Commission clarification and DWP regulations, on engagement and the public good. It will also counter the still common assumption that targeting short-term performance is compliant.

The guidelines should set out the types of activity that this duty implies that is, stewardship as well as investment, to be specified in mandates to asset managers and taken account of when their performance is assessed.

The guidelines should also suggest how these activities might be performed. This will not be prescriptive but will help set norms of behaviour. For example, the guidelines should suggest that asset owners work with other asset owners on stewardship,[48] and that they issue mandates requiring asset managers to engage actively with companies and to incentivise company manager to focus on long-term performance and those aspects of the public good likely to have an impact on portfolio value. The guidelines should

[46] See Annex 2, section 7

[47] See section 3.5 for comparable duties that would apply to asset managers. We recommend similar obligations are placed on financial advisors, but the specification of these is a separate topic for a separate paper.

[48] The Association of Member Nominated Trustees Red Line initiative is a good example of this already happening and its difficulties illustrates why change in the duties of asset managers is needed (AMNT)

also suggest that asset owners assess asset manager performance using metrics and narrative reporting that reveal the long-term prospects of the portfolio and the quality of corporate engagement, that they take suitable advice on this if needed, and only use quarterly valuations as a secondary method.

3. *Adopt robust procedures for deciding what will materially affect the financial value of the portfolio, including consulting with and reporting to savers.*

This will fill the third gap in the Law Commission clarification and DWP regulations, on the procedure for identifying financially material factors. In doing so it will help ensure asset owners are properly accountable to savers, including on how to target the public good.

The guidelines should require asset owners to consult widely with experts on factors that may be material to portfolio value. This would ensure that factors that may be material are not simply ignored because they have not been considered in the past. It would force environmental and social issues onto the agenda and is therefore in line with recommendations made in several other reports.[49]

Asset owners should also have to gain the approval of savers for decisions on which of these factors are material, together with the rationale for these decisions. If for example they decided that aggressive tax avoidance, while mentioned during the expert consultation, was in practice not likely to damage either individual company value, or, through its impact on the public good, portfolio value, they would need to set out their reasons for this view and get the approval of savers for their decision. It is highly likely that trustees' decisions would be approved most of the time, but the process would ensure that savers' views on investment strategy and on environmental and social issues were heard and that trustees' decisions were exposed to scrutiny.

4. *Consult savers on other factors potentially affecting their interests or on which they may have ethical preferences and act accordingly.*

This will fill the fourth gap in the clarification and regulations.

The guidelines should make clear that the consultations with experts and savers just described should be combined with similar consultations on financially *immaterial* factors. Note that 'financially immaterial' factors include all factors which are judged not to have a material impact on future portfolio value, however *they may have a material financial impact on savers through other channels* (for example climate change may reduce salaries or raise taxes in the future), as well as on wellbeing more broadly defined. In addition, there are factors which are of concern to savers for purely ethical reasons (the Law Commission uses investment in cluster bombs as an example).

The guidelines should make explicit that where there is a clear majority in favour of a given factor, trustees should be *obliged* to take this into account in the default fund (the fund where savers' money goes in the absence of instructions to the contrary) while offering the minority an alternative. The result would be 'informed consent' by the saver to the policy adopted—a principle that has attracted wide support.[50]

The guidelines should set out what acting on these factors implies, that is, corporate engagement as well as investment, including the issuing of mandates to asset managers and the assessment of their performance. They should also contain suggestions as to how these activities should be performed in the same way that they do about activities designed to maximise portfolio value.

Asset owners would also have to report to savers on the policies incorporating these decisions, and on how these policies had been implemented. This is in line with the new DWP regulations and recommendations made in several other reports.[51]

Legislation and guidelines of this type need not create the rigidity that made the Law Commission reject codification in 2014.[52] The argument against codification presented by the Law Commission was that it can create rigidity—

[49] See Annex 2, section 7.2
[50] See Annex 2, section 7.3
[51] See Annex 2, sections 6.2 and 7.4
[52] Law Commission 2014

the law needs to retain "suppleness" if it is to respond to social developments. Codification might also have unintended consequences and the process of introducing the legislation could be "lengthy and laborious". These points were made in very general terms, rather than to argue against the content of any proposed code. Some consultees agreed, and some disagreed, the latter tending to think, in the words of the Law Commission that "case law is a slow and backward way to formulate the law." Legal and General, for example, argued that "we cannot rely on the courts to respond to the rapid developments in this field". It seems to us indisputable that the process favoured by the Law Commission—clarification by the Commission itself and the on-going evolution of case law—has been shown to be quite incapable of delivering the kind of major changes to the bulk of investment intermediaries' behaviour that this paper argues are needed. We accept that detailed regulation might create rigidities, which is why we are not advocating it, but we do not see that the four broad requirements we propose are likely to change significantly in the medium term and therefore see no reason why they should be restrictive. Indeed, they can form the basis for a new evolution of case law. The more detailed guidelines may need to be revised from time to time, but they can be subject to periodic review by regulatory bodies.

There is as so often a danger of being half-hearted. As the EU High Level Expert Group on Sustainable Finance said of its proposals on investors' duties, "If this proposal is implemented in a partial or voluntary way, the regulatory situation will not make sufficient progress on driving sustainability across the investment chain."[53] We suspect that the rejection of codification by the Law Commission was based on a hidden assumption that a significant change in outcomes was not needed.

A further, technical objection to the proposals could be that the duties created by this legislation should be kept distinct from fiduciary duty as such, which should be retained unamended as a set of background obligations.[54] We do not have a view on this, and it is immaterial to our argument.

4.2 | Extending complementary duties to investment consultants and asset managers

Smaller asset owners lack the in-house capacity to perform their functions and are therefore heavily dependent on advice from investment consultants. They often lack the capacity to challenge this advice so that in effect they delegate their decision making to the consultant. This is an argument for consolidation amongst asset owners and we return to this in section 5, but it is also an argument for extending complementary duties to investment consultants, whose advice often amounts to a decision.

Asset owners may lack the knowledge and market power to ensure that asset managers do what they, the asset owners, need them to do to perform their newly defined duty. Again, this is an argument for consolidation amongst asset owners, but it is also an argument for extending complementary duties to asset managers.[55] While they are already obliged to act in "the best interests" of clients and to disclose how they comply with the FRC's stewardship code (of if they don't, what their alternative approach to stewardship is),[56] in practice, particularly when it comes to stewardship, they can be resistant to taking instructions from their clients and need a stronger incentive to do what their clients the asset owners are asking of them.[57]

Some savers are direct clients of asset managers, rather than through asset owners, and their interests need to be protected as well.

[53] EU High Level Expert Group on Sustainable Finance 2018

[54] In line with some submissions to the Law Commission's consultation on fiduciary duty

[55] The changes recommended could involve stipulating that asset managers, investment consultants and the managers of contract-based pension schemes are fiduciaries and therefore subject to fiduciary duty

[56] FCA COBS rules 2.1.1 and 2.2.3

[57] The challenges facing the Association of Member Nominated Trustees' 'Red Line' initiative, designed to get asset managers to adopt certain engagement and voting policies, is evidence of this. It has been put to us that asset managers cannot simply act as delegates for their clients as different clients ask for different things. The response is obvious: in the case of informal engagement it is to communicate the balance of opinion to company directors, and in the case of voting to split the vote. Of course, asset managers can and should advise their clients on what line to take and try to reach a common view, but it is for the clients to decide, in line with their savers' interests and preferences. It is possible that this particular issue may need explicit back up regulation.

This is an additional reason for extending complementary duties to asset managers.

We therefore recommend that versions of the newly defined fiduciary duty are extended to investment consultants and asset managers. This is in line with recommendations in several other reports.[58] It could allow savers, or asset owners on behalf of savers, to sue in cases of breach. In short, it would increase investment consultants' and asset managers' incentive to advance investors' interests as clarified by Parliament.

For investment consultants, the duty would be to provide advice that helps their clients perform their duty and follow the principles set out by Parliament. The form of this advice should not be prescribed by a regulator, but the Government should ensure that a suitable industry body, for example the Institute of Actuaries, draws up guidance on what this advice is likely to include.

For asset managers, the duty would be the same as that of asset owners, except that the duties to consult would be duties to consult with clients (asset owners or savers as appropriate). As with asset owners' duty, Parliament should publish guidelines making explicit the activities the duty covers—stewardship, including the briefs given to proxy advisors, as well as investment[59]- and some aspects of how these activities should be performed: in line with the objectives and concerns of clients,[60] in co-operation with other managers where appropriate,[61] focussing on long-term performance where this is in the interests of clients, and focussing on those aspects of the public good that are likely to have an impact on portfolio value. Like asset owners, asset managers would have to consult widely with experts on factors that may be material to portfolio value and gain their clients' approval for their decisions on which are material, together with the rationale for these decisions. They should also consult on which financially *immaterial* factors to take into account and engage with companies on. This would ensure that clients' views on investment strategy and on environmental and social issues were heard, in line with recommendations in several other reports.[62] Those parts of the duty covering engagement should also be codified in a revision of the FRC's Stewardship Code.[63]

[58] See Annex 2, section 8
[59] See Annex 2, section 8
[60]
[61] The Investor Forum is designed to facilitate this—it was set up following recommendations from Kay (Kay 2012)—but it has not yet been especially effective according to some leading asset managers. This is an example of how setting up structures is pointless if you don't create the right incentives.
[62] See Annex 2, sections 7.3 and 8
[63] See Annex 2, section 7.5

5

Equipping intermediaries to respond to these new incentives

To respond to these new incentives, to perform their fiduciary duty, intermediaries will need new information and new capabilities. This section is therefore about what government needs to do to improve the flow of information and improve intermediaries' capabilities. It is largely a synthesis of recommendations made in other reports.

Government has a role for several reasons. First, new information flows and capabilities sometimes require collective action in the industry, and government is well placed to catalyse this. Second, some intermediaries will have difficulty developing capabilities, and government can encourage the necessary training. Third, the structure and governance of the industry may form barriers and government can help remove these. Finally, there may be regulatory and other barriers which government can help remove.

5.1 | Improving the flow of information

Intermediaries need several different kinds of information if they are to respond to the incentives:

- *Asset managers* need better information from companies about the drivers of long-term performance and risk that they face, including environmental and social factors, and about their strategies
- *Asset managers* also need reliable information from companies about their contribution to the public good
- *Asset owners* also need these various kinds of information from companies, as well as better information from asset managers about how they have engaged with companies on the basis of this information.
- *Asset owners* also need better information from asset managers about their portfolios' long-term prospects if they are to abandon quarterly valuations as an assessment method.

There have been numerous recommendations on the provision of information by companies, particularly on environmental and social factors. For example: abandoning quarterly reporting,[64] better narrative reporting by companies of factors, including environmental and social factors, that are likely to drive long-term financial performance, better narrative reporting of the risks to that performance[65] and of climate change strategies,[66] better metrics to back up this narrative reporting,[67] and better and more standardised reporting and metrics of companies' contribution to the public good.[68]

There have also been numerous recommendations on the provision of information by asset managers. These cover performance metrics and models,[69] risk quantification, and voting records.[70]

Partly as a result of these recommendations, a wealth of work is taking place on metrics and models of different types.

The problem is lack of common standards and a requirement to follow them. In this respect, new metrics and narrative formats are unlike traditional accounting standards. There have been several recommendations designed to address this problem, for example it has been proposed that the Financial Stability Board Taskforce on Climate Related Disclosure recommendations be made mandatory after a short voluntary trial period, building on the French experience.[71] [72]

[64] EU High Level Expert Group on Sustainable Finance 2018, Kay 2012
[65] Kay 2012, UN PRI 2016
[66] TCFD 2017
[67] UN PRI 2016, FSB 2017, EU High Level Expert Group on Sustainable Finance 2018
[68] Share Action 2011, UN PRI 2016, Corley 2017
[69] Kay 2012, ShareAction 2016, FCA 2017, EU High Level Expert Group on Sustainable Finance 2018
[70] Share Action 2011, Aviva 2014, ShareAction 2016
[71] TCFD 2017, EU High Level Expert Group on Sustainable Finance 2018
[72] Disclosure is mandatory in France, specified in Article 173 of the 2015 Law on Energy Transition and Green Growth

We recommend government uses its convening power to facilitate standards for new forms of reporting. These would be designed to provide guidance on long-term prospects and on environmental and social records, at company and portfolio level, and in both narrative and quantitative form.[73] This should be backed up by the threat of regulation if need be. It should also encourage work on the links between environmental and financial risk.[74]

5.2 | Capabilities

Asset managers will need to become more proficient at

- **changing company managers' incentives** towards long-term financial success and the public good, through engagement and working with other asset managers as need be
- **evaluating the impact of environmental and social factors on future company performance, and existing contribution to the public good.**

There have been recommendations in other reports for training asset managers and advisors in sustainable finance,[75] in employment issues[76] and in impact investment.[77]

Asset owners will need to become more proficient at

- **engaging with savers**, using information technology as appropriate
- **managing their asset managers,** particularly their engagement with companies, and working with other asset owners as need be
- **evaluating their asset managers**, using new kinds of information, including about environmental and social factors.

There have been recommendations in other reports that asset owner learning networks should be established,[78] that training should be provided[79] and even made compulsory for the boards of asset owners,[80] and that steps should be taken to ensure these boards are 'fit and proper' given the tasks they face.[81]

We recommend the Government request regulators and industry bodies develop and promote training packages when the new guidance on the duty is published. These would be designed to ensure asset owners and asset managers can do what is necessary to perform that duty. Once the courses are working effectively it should consult on either introducing a qualification based on them or making them compulsory.

5.3 | Structure

Some asset owners may be too small to perform these functions adequately, partly because of the range of specialist skills required, and partly because greater size may be needed to negotiate effectively with asset managers. Several commentators have noted this, and have recommended that government encourage consolidation, as happened in the Netherlands where the regulator put pressure on smaller funds.[82] It has also been suggested that consolidation could be driven by a duty on asset owners to consider whether they had sufficient scale.[83] In addition, it has been recommended that the DWP remove barriers to pooling.[84]

Government is encouraging consolidation and we recommend it continues to do so. There are significant regulatory and practical barriers to consolidation and Government should remove regulatory barriers, while instructing the Pensions

[73] Seaford 2017
[74] G20 Green Finance Study Group 2016 and 2017
[75] Aviva 2014
[76] ShareAction 2016
[77] Corley 2017
[78] G20 Green Finance Study Group 2016 and 2017
[79] ShareAction 2011
[80] ShareAction 2015
[81] EU High Level Expert Group on Sustainable Finance 2018
[82] ShareAction 2011, ShareAction 2015, https://www.towerswatson.com/en/Insights/Newsletters/Europe/UK-Corporate-and-Trustee-Briefing/2017/08/Pension-scheme-consolidation-lessons-from-overseas
[83] UN PRI 2016
[84] FCA 2017

Regulator to play a more active role, following the Dutch example.

We also recommend changes to rules on asset owner governance. These would be designed to increase asset owner responsiveness to their customers and our recommendation echoes proposals in other reports. Occupational pensions scheme boards should include elected representatives of beneficiary groups, who should have the right to paid time off work and who should be diversity monitored.[85] Where the asset owner has a contract-based rather than trust-based relationship with savers, the Independent Governance Committee, which represents the interests of savers, needs to be subject to the same duties as trustees, and then be given the decision rights and resources it needs to perform the functions described in the guidelines on fiduciary duty set out by Parliament.[86]

5.4 | Other barriers

There may be other barriers to performance of duties of care which need regulation or deregulation if they are to be overcome. Some issues mentioned in other reports include:

- **The nature of benchmarks**, which, since they are used as the basis for passive funds, may drive funds in directions savers do not want. [87] Notably, a report from Bright Blue argued that "the composition of the FTSE 100 should be reviewed, and serious consideration given to creating a more balanced UK blue chip index that better reflects what UK investors, particularly retail investors and asset owners with UK beneficiaries and sterling liabilities, want from the main index—something more genuinely UK centric that also supports UK businesses and investors".[88]
- **Regulatory requirements for mark to market valuation** which may create pressures for short-term performance [89]
- **Regulator mandates which lack any reference to ESG** or sustainable development factors or to impact investment or to the impact of social outcome on risk in the mandates of regulator s[90]
- **Regulatory barriers to innovative products** that make green investment or other investment with social as well as financial returns more likely
- **Regulatory barriers to illiquid assets.**[91]

[85] ShareAction 2015, UN PRI 2016
[86] ShareAction 2015, UN PRI 2016
[87] EU High Level Expert Group on Sustainable Finance 2018
[88] Caldecott 2015 - 1
[89] EU High Level Expert Group on Sustainable Finance 2018
[90] Aviva 2014, Corley 2017
[91] Corley 2017

6
Conclusion

The changes proposed in this paper will not by themselves transform capitalism or deliver sustainable prosperity, but they will make a contribution, and will help make changes to corporate governance and 'real world' regulation more effective. Their role is to ensure that the interests of the typical saver have more weight amongst company managers when decisions are being made than is currently the case. These interests are in long-term as opposed to short-term financial success, and in certain aspects of the public good. The changes work by incentivising asset owners and asset managers—that is the intermediaries who act for savers—to change company managers' incentives towards achieving these objectives, and to exert other forms of pressure on company managers along the same lines. This incentivising of intermediaries is achieved by specifying in more detail the fiduciary duty that they owe their clients and savers, and in this way creating opportunities for activist groups to sue should the intermediaries fail to perform. Fear of litigation is one of the most powerful motivators in the pensions industry and can help change the culture. Intermediaries will also need to be equipped to perform this new role, and government also has a crucial role in ensuring that they are.

Ensuring an effective investment industry has been largely delegated by politicians to regulatory bodies, on the assumption that the measures needed have little relevance to wider social and economic issues. The argument of this paper suggests that this assumption is false, and that therefore politicians could usefully consider what may have been seen as purely technocratic issues.

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Annex 1

The two main parties' manifestos

Conservative manifesto objectives

The Conservative Party Manifesto in 2017 makes clear that the Government's economic policy objective is not simply growth but **balanced growth**:

- "We will develop our ambitious modern industrial strategy to get the economy working for everyone, across the whole of our nation… bringing secure, well-paid jobs to the whole of the country."

This will be achieved in part by investment **in innovation**:

- "So that overall, as a nation, we meet the current OECD average for investment in R&D—that is 2.4% of GDP—within 10 years, with a longer-term goal of 3%".

While government will contribute to this, the Conservatives remain a low tax party—so the bulk of the growth in investment will have to come from industry itself.

Equally, if not more important, will be **investment in people**:

- "government to take on… Britain's lack of training and technical education" and provide "a modern technical education available to everyone throughout their lives."

Again, this investment will be **in partnership with business**:

- "We will establish new institutes of technology, backed by leading employers and linked to leading universities in every major city in England… Above all, they will become anchor institutions for local, regional and national industry… we will put employers at the centre of these reforms"
- "3 million apprenticeships for young people by 2020"
- "a new right to request leave for training."

More generally, the hope is that **large companies will take account of the interests of all stakeholders:**

- "Boards should take account of the interests not just of shareholders but employees, suppliers and the wider community"

Government may still need to **protect the interests of stakeholders**:

- "We will not only guarantee but enhance workers' rights and protections"
- "fair markets for consumers"
- "big companies comply with the prompt payment code"

It will also **constrain socially damaging strategies**:

- "we want investors to succeed but not when success is driven by aggressive asset stripping or tax avoidance"
- "we will update the rules that govern mergers and takeovers"

And **constrain boardroom excess:**

- "The public is rightly affronted by the remuneration of some corporate leaders… The next Conservative government will legislate to make executive pay packages subject to strict annual votes by shareholders… we will commission an examination of the use of share buybacks"

Nonetheless, the aim is to **avoid too much regulation, and create a partnership**:

- "poor and excessive regulation"
- "a partnership… between private sector and public service"

This can be a built around a shared **commitment to country and the common good**:

- "True Conservatism means a commitment to country and community…. Change should be shaped for the common good."

Finally, the manifesto highlights the **importance of income from private pensions**:

- "If we are to give older people the dignity we owe them… we face difficult decisions"
- "We will continue to support the successful expansion of auto-enrolled pensions… we will promote long-term savings and pensions products."

The manifesto contains little about the **shift to a sustainable, low carbon economy,** presumably because this is now underway. Nonetheless we assume this remains an objective.

Labour Manifesto objectives and policy initiatives

"An economy that works for all" is the overarching economic policy objective set out in the 2017 Labour manifesto. This will be a low carbon, environmentally sustainable economy.

This requires a "a fair deal at work" which provides "security and fulfilment." A range of tools to achieve this are proposed: labour market regulation, stronger trade unions, public investment, skilful use of public procurement and so on.

However, it also requires business to invest more in skills and innovation. For the aim is to create:

- "An innovation nation with the highest proportion of high-skilled jobs in the Organisation for Economic Co-operation and Development by 2030… [and that] will meet the OECD target of 3 per cent of GDP spent on research and development by 2030."

This in turn requires business and government to work together effectively. So, for example, "Employer led training is the most effective way of meeting our growing skills gap" but at the moment this potential is not being realised, so government will need to "take steps to ensure that every apprenticeship is of a high quality".

More fundamentally it requires that the *purpose* of business be addressed:

- "when shareholders are looking for quick short-term returns, they encourage companies to cut corners… the long-term growth of a company can be sacrificed for the sake of a quick buck."

In other words, "the power of finance to work for the public good" is generally not being used.

That is why "Labour will transform how our financial system operates" and reform corporate governance

- … [to] make sure they [companies] stay focused on delivering shared wealth… [and] that directors owe a duty directly not only to shareholders but to employees, customers, the environment and the wider public".

More generally it will introduce "more democratic ownership structures".

Recently Labour has started to flesh out some of the policies needed to achieve these objectives. For example, it has developed plans for "ownership funds" which would eventually own 10% of companies with more than 250 employees and pay dividends of up to £500 to workers. One third of the directors would have to be worker representatives.

Annex 2

Additional evidence

This annex contains additional support for statements and arguments made in the main text. Each section is referred to at one or more points in the footnotes to the main text.

1 | Short-termism

1.1 There is evidence that long-term strategies make the economy stronger, for example by encouraging investment in innovation and skills.

In principle short-termism will reduce investment (certainly investments that accountants treat as costs such as training and research) and thus reduce growth in the capital stock and thus increases in labour productivity and thus economic growth. It is difficult to establish the consequences of short-termism definitively—the issue is contested and the Kay Review[92] did not resolve it: it only showed that short-termism existed, not what its economic impact was. After all, we cannot compare two economies that are similar other than in the prevalence of long-term strategies. However, there is evidence, from the US that "firms that [only] just meet earnings targets lower their investment in R&D and intangibles," presumably in order to ensure they hit the targets next time. When the effect of this is modelled, it suggests that the resulting misallocation of R&D between firms cuts economic growth rates by 0.1% p.a.[93] This is a rather small effect—we might expect a bigger effect if the model were extended to include investment in skills and other assets.

1.2 There is also evidence that attending to 'ESG' is more likely to be part of strategies for long-term success than strategies for short-term success

There is evidence that attending to ESG is good for financial performance over the long-term.

Thus, the International Corporate Governance has reported that:

- A 2015 aggregated meta-study that reviewed around 2,200 empirical studies relating to ESG and corporate financial performance reveals that roughly 90% of studies find a non-negative relation between ESG and corporate financial performance. The large majority of academic studies report positive findings and concludes that the positive ESG impact on corporate financial performance appears stable over time.[94]

However, a recent study[95] suggests that short-term profit pressures on public companies prevent them from devoting resources to corporate social responsibility (CSR), in part at least because it is a diversion "from the short-term to the long-term". (This does not apply to private businesses or to businesses with consumer facing brands where responsibility is contributing to the brand value.) While ESG is not the same as CSR —ESG is normally used to refer to factors that will have a positive impact on value, at least in the long-term—many managers will in practice conflate the two. The reason there is a diversion from the short-term to the long-term is that the potential positives of attending to ESG (beyond consumer brand building) include attracting talent and mitigating certain kinds regulatory and reputational risks. These are more likely to have effect over the long-term than in the short-term. As the authors of another study put it "CSR signals that companies are overcoming the logic of the short-term."[96]

1.3 There is also evidence that some company managers sacrifice long-term financial success in order to achieve short-term financial success

As Kay put it in his review, "We identified many cases in which poor decision-making had damaged the long-term success of the company."[97] The results of such decisions are a decline in investment: "as a share of national income, business investment in the UK has declined over the past decade….As a percentage of GDP,

[92] Kay 2012
[93] Terry 2015
[94] Friede et al 2015 quoted in International Corporate Governance Network 2018
[95] Li and Wu 2016
[96] Lombardo and D'Orio 2012
[97] Kay 2012

research and development expenditure by British business has been in steady decline…The UK invests a smaller percentage of its GDP in research and development than its principal trading competitors". Thus "there is some evidence here that British managers are less concerned with the long-term than their predecessors, or their competitors."

More striking evidence comes from the US. One study reported that almost 80% out of 400 CFOs of large US companies would sacrifice economic value for the firm in order to meet that quarter's earnings expectations.[98]

1.4 'Traders' have more influence on share prices than 'investors'

Kay points out that "Hedge funds, high frequency traders and proprietary traders are responsible for 72% of market turnover (but a small proportion of shareholding)." Since it is transactions that drive prices, they have a disproportionate influence on prices.[99]

2 | Inclusion, trust, economic performance and Brexit

2.1 There is evidence that inequality (one aspect of a non-inclusive economy) reduces social trust.

A 2016 paper from the IMF examined whether "the downward trend in social capital is responding to the increasing gaps in income" based on data from the American National Election Survey (ANES) from 1980 to 2010, and the European Social Survey (ESS) from 2002 to 2012. The results provided "robust evidence that overall inequality lowers an individual's sense of trust in others in the United States as well as in other advanced economies."[100] This largely settles a debate about whether the widely reported correlation between inequality and trust based on cross-sectional international studies did really indicate a causal relationship in developed countries.[101]

2.2 There is also evidence that social trust is good for economic performance.

Trust in strangers is one dimension of "civic capital," which has been defined as "Those persistent and shared beliefs and values that help a group overcome the free rider problem in the pursuit of socially valuable activities," and, more generally, as "the set of values and beliefs that foster cooperative behaviour."[102] The authors of this definition have shown that there is a "strong correlation" between civic capital, and especially with trust in strangers, and "level-measures of economic development—such as GDP per capita." Furthermore, "much progress has been made to pin down the causal effects of civic capital on economic outcomes"—although, as ever, establishing causality remains somewhat problematic.

2.3 Low levels of trust are part of the explanation for Brexit

Low levels of trust in politicians appear to have been a driver of 'leave' voting. A study based on the 7th Wave of the British Election study concluded that "there is a strong impact of lack of trust in politicians on the Leave vote: one standard deviation increase in distrust leads to a 9 percentage point increase in the probability of a Leave vote."[103] Other studies have shown that low educational attainment was the strongest correlate with a leave vote, and, interestingly, that the average educational attainment in an area was a significant driver independently of individual attainment (ie graduates in poorly educated areas were more likely to vote leave than were graduates in well-educated areas; those with A-levels were likely to vote leave in poorly educated areas and remain in well-educated areas). This suggests that place-based exclusion was a driver of the vote.[104]

[98] Graham et al 2005
[99] Kay 2012
[100] Gould and Hijzen 2016
[101] Kawachi et al 1997, Steijn and Lancee 2011
[102] Guiso et al 2010
[103] Hobolt 2016
[104] Goodwin and Heath 2016

2.4 Higher overall skills levels are associated with higher levels of profits

Not surprisingly, there is a strong association between skill levels and productivity (some of the evidence has been summarised in a report from the Institute of Employment Studies).[105] There is also a strong association between productivity and profit margins.[106] Thus there is most likely an association between skill levels and profit margins. This is plausible since product differentiation may require high skill levels and tends to generate high profit margins.

3 | Investors' broader interests

3.1 Many savers have an interest in the companies they invest in paying fair levels of tax

Saker Nussebeih has made the point thus:

- To illustrate this point, allow me to use three examples. In the first example, the investor owns shares in company A. Company A uses perfectly legal methods to pay less tax than it should and as a result its earnings go up and its share price goes up. In a narrow sense, the investor has made an additional economic gain equivalent to that rise. However, she still lives in the same society in which that company operates. Tax revenues for the government are reduced by that amount. That means that either government will need to cut services or raise taxes to make up the difference. In both cases, the investor loses the gain on the share by her share of the amount of additional tax or reduced service. In other words, by looking at both sides of the ledger, we can demonstrate that such a gain was a mirage. This even applies within the context of companies operating internationally because the saving pool of the world is interconnected in our globalised capital markets.[107]

3.2 An increasing number of savers have an ethical preference for the companies they invest in to take account of the public good

Ethical investors are now a potentially significant part of the market. It was reported in early 2018 that "According to data on investor preferences, put together by London-based investment firm IW Capital, 24% of investors would refrain from pursuing an investment decision because of ethical concerns over the product or service. Of 2,004 respondents, almost a third said the ethical, social or environmental impact of the company they were investing in was just as important as the financial return."[108]

3.3 Ethical investment has had some but limited impact

One study from five years ago concluded that "SRI [socially responsible investment] does not yet play a major role in changing ESG performance."[109] As Mike Barry, Director of Plan A at Marks and Spencer has put it more recently, "the investor pressure for good tends to be a bit like NGO pressure."[110] There have, however been some individual successes—ShareAction has listed sources describing these.[111]

4 | Asset manager corporate engagement

4.1 Active asset managers rarely challenge short-term profit maximisation when engaging with companies.

As Lord Myners has put it:

- The fund manager is told by his client, "We want you to out-perform the index over rolling three-year periods," either a broad index or an industry-specific risk…. The fund managers then try to put similar obligations on the company chief executive, and the board directors are told that their bonus is dependent upon how well the share price

[105] Tamkin 2005
[106] Tamminen et al 2016
[107] Nussebeih 2017
[108] New Model Adviser—a trade magazine for financial advisers—reported in February 2018
[109] Wagemans et al 2013
[110] Seaford 2019
[111] ShareAction 2016 -3

does over a rolling three-year period. The fund manager feels under a short-term performance pressure, and so they absolutely replicate that in the arrangements put in place for company bonuses.[112]

4.2 There are free-rider problems associated with corporate engagement.

The problem was stated rawly by an amateur pension fund trustee sympathetic to sustainable investment (she was Director of Sustainable Financial Markets at Forum for the Future):

- There are a few fund managers that are clearly engaging more actively with companies than others, to improve their social and environmental standards. Maybe this has a positive knock-on effect for all of us. But I'm not keen for my own pension fund to bear the cost of that engagement… It's expensive to be a leader. There is a problem with free-riding on a few fund managers' strategy of active engagement with companies. Active engagement with companies is expensive and it makes sense to reap the benefits from others doing the work. This creates a clear disincentive to be a leader in this space.[113]

5 | Asset owner behaviour

5.1 Asset owners tend to satisfice rather than maximise performance

This conclusion is based on our extensive discussions in the industry including the conversation at a roundtable in April 2017 largely for asset owners. However, others have reached a similar conclusion. Lord Myners has said:

- I stand by the importance of having trustees who are better qualified, more knowledgeable and more independent-minded, and who approach their responsibilities in a more business-like way….
- He who pays the piper calls the tune. The problem has been that the person who pays the piper has been somnolent and has expressed no particular preferences for any type of tune, or even the quality of playing. He who pays the piper is the trustee of the pension scheme. In that area, I absolutely remain on rock-solid ground with my own review on institutional investment, which could be summed up as saying that the pension fund trustees have just got to get smarter and be more on the ball. That is a source of change, Mr Walker. Achieving that is more important than anything else.[114]

5.2 An example of inertia is the continuing misunderstanding of the nature of fiduciary duty

Kay reported that many trustees equated their fiduciary responsibilities with "maximising financial returns over a short timescale"[115] and as a result, the Law Commission published a clarification of fiduciary duty two years later. The situation may now be improving—but from a very unsatisfactory starting point. In their submission to the Law Commission's consultation conducted as part of this exercise, ShareAction reported:

- In response to member emails asking about their position on climate change, 25% of funds referenced fiduciary duty—half as a reason to act on climate change, the other half as a reason to ignore it. In our view, there could scarcely be a better demonstration of the continuing confusion that surrounds this question.[116]

Leading investment consultant Towers Watson said, in their response to the same consultation that

- Pension fund trustees often feel that the burden of proof is on them to make the case for sound long-term investments (eg sustainable investing); a burden of proof that they do not feel exists to the same extent when investing in the short-term.[117]

Aviva Investors reported that

- The law is sufficiently clear that trustees must invest in the best interests of the ultimate beneficiaries. At the present time the law does

[112] Myners 2013
[113] Chapple 2011
[114] Myners 2013
[115] Kay 2012
[116] Law Commission 2014
[117] Law Commission 2014

> appear to place the obligation on trustees to factor in long-term considerations such as sustainability. However, for a myriad of reasons … the letter of the law is not being followed and the majority of trustees are giving insufficient attention to this highly pertinent topic.[118]

They went on to explain that it was "common for institutional investors to default to an interpretation of their duties which requires them to focus solely on maximising profit for the beneficiaries in the short-term."

Another commentator has argued that "the focus on fiduciary duty as a barrier masks the role of trustee behavioural biases toward inertia and short-termism."[119] It has also been suggested that because decisions are taken as a group, trustees also tend to "converge towards more socially acceptable normative behaviour."[120]

5.3 One example of satisficing is the use of quarterly portfolio valuation, which the evidence shows is a very poor method of assessing asset manager performance

The Financial Conduct Authority (FCA) has summarised the UK and US evidence on performance persistence.[121] It concluded that "the implication of the above evidence is that past good performance is empirically not a good predictor of future good performance for most funds and asset classes, and therefore is not a good indicator for investors looking for outperformance." The evidence on non-persistence of out-performance is particularly vivid for the US: "Of the 664 US equity funds that were in the top quartile of performers as of March 2012, only 0.30% remained in the top quartile in March 2016…. Similarly, of the 1,328 US equity funds that were in the top half of performers in March 2012, only 6.02% remained in the top half at the end of March 2016."

There is some evidence, however, that *under*performance does persist to a limited extent. Thus, the FCA report continues: "we find that 11.4% of funds which were in the bottom quartile of performance between 2005 and 2010 continued to be in the bottom quartile in the subsequent five years. We consider this is evidence of relative poor performance persistence. In addition, 35% of the funds that were in the bottom-performing quartile over 2005-2010 subsequently closed or merged over 2011-2015."

5.4 The misunderstanding of fiduciary duty is despite the correction published in 2005 by leading law firm Freshfields Bruckhaus Deringer.[122]

The authors of this report—published nine years before the Law Commission report— started by making clear:

- Where the purpose of their investment power is to seek a financial return for the beneficiaries, as in the case of financial trusts such as most pensions, decisionmakers must treat this as their overriding objective when making decisions in relation to the funds they control.

However, they went on to say:

- This does not, however, require the pursuit of profit maximisation on an investment-by investment basis as is often argued in the UK. Such an assertion arises from case law that we regard as no longer reliable. Rather, the US approach, which focuses on the returns realised across a well-managed portfolio as part of a rational investment strategy, appears to better reflect modern investment reality and is likely to be the approach a UK court would follow today.

They concluded that:

- The links between ESG factors and financial performance are increasingly being recognised. On that basis, 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. It is also arguable that ESG considerations must be integrated into an investment decision where

[118] Law Commission 2014

[119] Woods (2009

[120] Weiss-Cohen 2017

[121] FCA 2016, paragraphs 6.46 to 6.55

[122] Freshfields Bruckhaus Deringer 2005

a consensus (express or in certain circumstances implied) amongst the beneficiaries mandates a particular investment strategy and may be integrated into an investment decision where a decision-maker is required to decide between a number of value-neutral alternatives.

5.5 It is widely recognised that savers cannot normally judge whether asset owners are doing a good job—hence calls for greater financial literacy

At a recent roundtable we attended (November 2018) a senior executive in the pensions industry confirmed that 'financial literacy' was the most commonly proposed reform she had heard in the last two years—in other words there is widespread agreement that the ability to judge suppliers effectively did not exist.

Several organisations have also made this recommendation, for example ShareAction has called for current and future investors to educated as to what investment means,[123] Aviva has called for integrated sustainable finance to be in national curricula by 2020[124] and the EU High Level Expert Group on Sustainable Finance has argued that financial literacy should be actively promoted.[125]

6 | Work by the Law Commission and the DWP on asset owners' duties

6.1 The Law Commission published a clarification of fiduciary duty (which creates an obligation to advance the interests of those you represent) in 2014.[126]

The Commission's own summary reads as follows:

- The report concludes that trustees should take into account factors which are financially material to the performance of an investment. Where trustees think ethical or environmental, social or governance (ESG) issues are financially material they should take them into account.

  However, while the pursuit of a financial return should be the predominant concern of pension trustees, the law is sufficiently flexible to allow other, subordinate, concerns to be taken into account. We conclude that the law permits trustees to make investment decisions that are based on non-financial factors, provided that:
  - they have good reason to think that scheme members share the concern; and
  - there is no risk of significant financial detriment to the fund.

The Commission published further recommendations in 2017. [127]

6.2 In September 2018, the DWP laid regulations before Parliament building on the Law Commission work

The regulations and the changes made following consultation with the industry are set out in the Government's response to the consultation.[128]

The draft regulations published in June 2018 would have required trustees to:

- where they are required to produce a Statement of Investment Principles (SIP), update or prepare it to set out:
  - how they take account of financially material considerations, including (but not limited to) those arising from Environmental, Social and Governance considerations, including climate change;
  - their policies in relation to the stewardship of investments, including engagement with investee firms and the exercise of the voting rights associated with the investment;
- in relation to relevant schemes—broadly, schemes offering money purchase benefits, subject to a few exceptions:
  - to publish their Statement of Investment Principles on a website so that it can be

[123] ShareAction 2013
[124] Aviva 2014
[125] EU High Level Expert Group on Sustainable Finance 2018
[126] Law Commission 2014
[127] Law Commission 2017
[128] Department for Work and Pensions 2018

found and read by both scheme members and interested members of the public, and inform scheme members of its availability via the annual benefit statement;

- in relation to the default arrangement, prepare or update their default strategy, to set out how they take account of financially material considerations, including (but not limited to) those arising from Environmental, Social and Governance risks, including climate change.
- when they next prepare or update their Statement of Investment Principles, …prepare a separate 'statement on member's views', setting out how they will take account of the views which, in their opinion, members hold, in relation to the matters covered in the Statement of Investment Principles. In addition, we proposed to require trustees of relevant schemes to publish that statement.
- of relevant schemes which are required to produce a Statement of Investment Principles to:
  - produce an implementation statement setting out how they acted on the principles they set out, and how they acted on the statement which covered how they would take account of the views which, in their opinion, members hold;
  - publish that implementation statement online in the same way as the Statement of Investment Principles and inform scheme members of its availability via the annual benefit statement.

These proposals have now been laid before Parliament, except that following the consultation, the Government has "removed the requirement to prepare a separate 'statement on member's views'" and "replaced it with an optional policy on non-financial factors, including not only members' ethical concerns, but also social and environmental impact matters and quality of life considerations."

The Government also made a point of affirming that "It is our policy—and will remain our policy—that trustees have primacy in investment decisions. Whilst they should not necessarily rule out the ability to take account of members' views, they are never obliged to do so."

7 | Other recommendations on the fiduciary duty of asset owners

7.1 Others have emphasised fiduciary duty as the way forward

Lord Myners has said

- I think it would be beneficial to have a more serious set of statements about fiduciary duty, in which, for instance, the trustees were placed under an undoubted and undeniable obligation to properly account for how they align the way in which they invest with the best interests of members of the scheme.

  If we emphasised the fiduciary responsibility, it would ultimately be a matter for the courts. If trustees or directors were failing, then they would run a risk of challenge from those who have placed them in a position of trust. I look at bodies like the FRC and the new FCA and somehow, Chair, I cannot convince myself that they are going to be able to make much change. The FRC, I think, is in a comfort blanket of believing that its stewardship code is making any real difference. When you speak to most company chairmen and chief executives-and I speak a lot with those people-they say, "Has the stewardship code changed? Are things fundamentally different and better?" They do not really see any change, but the FRC is able to say 200 fund managers have signed up to it and it is all terribly good. If there were clarity about fiduciary duty, the courts would be the ultimate enforcer.[129]

7.2 Others have made specific recommendations on amplifying the duties

The UN PRI has recommended that the duty to act in the best interests of beneficiaries should explicitly include the use of shareholder rights in corporate engagement, and has noted that "long-term factors (including ESG) are a core part of prudent investment decision-making," and that "best practice includes ESG integration, engagement with investee companies, considered use of shareholder rights and public-

[129] Myners 2013

policy engagement in beneficiaries' best interests".[130]

ShareAction has recommended that fiduciary principles should be developed to deal with "systemic risk and the collective action problems that this creates"[131] and has also recommended a series of "clarifications", some of which have been made by the Law Commission and some which would represent a further advance, mainly by making clear that the wider economic and other impacts of intermediary decisions and actions can be taken into account.[132]

Aviva has recommended that sustainable development be incorporated into the legal duties of market participants including fiduciary duty.[133]

The EU High Level Expert Group on Sustainable Finance has recommended that:

- The aim should be to make clear that in fulfilling their duties, investors should incorporate sustainability factors consistent with the broad interests, investment horizons and sustainability preferences of their clients and beneficiaries. It should also be clarified that stewardship of investments is a fundamental element of fulfilling these duties.

  Clarified duties would encompass key investment activities, including investment strategy, risk management, asset allocation, governance and stewardship. Making it clear that sustainability factors must be incorporated in these activities can ensure that the clarified duty is effective.[134]

At a CUSP roundtable held in October 2017, the consensus was that a duty to take into account the wider financial interests of beneficiaries should be considered further.

7.3 A duty to consult beneficiaries and so achieve informed consent to the investment policy is widely supported

For example, The EU High Level Expert Group on Sustainable Finance has recommended that:

- The clarified duty would also require that all participants in the investment chain pro-actively seek to understand the sustainability interests and preferences of their clients, members or beneficiaries (as applicable) and to provide clear disclosure of the effects, including the potential risks and benefits, of incorporating them into investment mandates and strategies.

  To be consistent with the duties for institutional clients, collective investment management companies will need to require informed consent from clients on sustainability issues. Under UCITS and AIFMD, this obligation would include consideration of the interests of all investors who are clients of the scheme. For retail clients, this should include the wider interests and ethical preferences on sustainability that the individual would wish to have taken into account. This should form part of 'know your client' assessments and the consideration of suitability required by MiFID II.[135]

Similarly, a taskforce on impact investment commissioned by the Government has argued that "know your customer rules" should include knowledge of his or her values and ethical preferences,[136] while ShareAction has argued that there should be an obligation to consult savers on investment and voting policies.[137]

At a CUSP roundtable held in October 2017, the consensus was that a duty to consult beneficiaries on how to treat ESG factors should be considered further.[138]

[130] UN PRI 2016
[131] ShareAction 2011
[132] ShareAction 2012
[133] Aviva 2014
[134] EU High Level Expert Group on Sustainable Finance 2018
[135] EU High Level Expert Group on Sustainable Finance 2018
[136] Corley 2017
[137] ShareAction 2013
[138] Seaford 2017

7.4 Reporting obligations have been widely recommended and have been partially adopted by the DWP.

For the DWP regulations see section 6.2 of this annex above.

Aviva has recommended that all principal capital actors in the investment chain should report on how they have integrated sustainability considerations into their activities (or explain why they have not done so).[139] This would include asset owners, investment consultants, asset managers, investment banks (advising investors), and proxy advisors. Asset owners, for example, should report on how they have integrated sustainability considerations into investment management agreements. Others have argued that plan sponsors should provide transparent and concise communication about the rationale for their investment decisions including ESG integration;[140] and that savers should know where their money is invested, how their ownership rights are exercised, what the investment policy is, including on responsible ownership or ethical investment, and how it is implemented, and how long-term risks are managed.[141]

7.5 Complementary changes to regulatory mandates have also been recommended

This can be partly achieved through changes to the mandates of regulatory bodies and both Aviva[142] and UN PRI[143] recommend changes to the mandates or codes of regulatory bodies (such as the FRC, FCA and the Pensions Regulator) to take into account sustainability principles. ShareAction has also recommended that the duty to engage is made more explicit in the FRC's Stewardship Code.[144]

8 | Extending complementary duties to investment consultants and asset managers

Kay recommended that "fiduciary standards" be applied to all relationships in the investment chain.[145] UN PRI has recommended that fiduciary duty (or a comparable duty) be extended to investment consultants.[146] ShareAction has also recommended that asset managers and investment consultants be "reminded" of their professional duty of care.[147] Ben Caldecott as recommended that the obligations of investment consultants should be reviewed, with a view to increasing their focus on the long-term and more effective working relationships with their clients.[148] Aviva's recommendations cited in section 7 largely apply to the whole investment chain.

At the CUSP roundtable held in October 2017, the consensus was that the duty should be extended to investment consultants, who should have a duty to provide appropriate advice, and to asset managers, who might have a duty to engage with corporate managers and to respond to the concerns of their clients (and, indirectly, of final beneficiaries).[149]

[139] Aviva's 2014
[140] UN PRI 2016
[141] ShareAction 2013
[142] Aviva 2014
[143] UN PRI 2016
[144] ShareAction (2011, 2016 - 1)
[145] Kay (2012)
[146] UN PRI (2016)
[147] ShareAction (2011)
[148] Caldecott (2015 -2)
[149] Seaford 2017

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