21 January 2014

Attn: Folarin Akinbami
Law Commission

Email: fiduciary.duties@lawcommission.gsi.gov.uk

Dear Sir/Madam

Response to UK Law Commission Consultation on Fiduciary Duty of Investment Intermediaries

We welcome the review of fiduciary duty by the Law Commission as an important next step following on from the Kay Review and appreciate the opportunity to respond to the consultation. We have paid close attention to the development of the debate and believe the Commission's contribution and analysis marks a significant step forward.

The United Nations-supported Principles for Responsible Investment Initiative (PRI) is a network of international investors working together to put the six Principles for Responsible Investment into practice to create a sustainable global financial system. The Principles were devised by the investment community and reflect the view that environmental, social and corporate governance (ESG) issues can affect the performance of investment portfolios and therefore must be given appropriate consideration by investors if they are to fulfil their fiduciary (or equivalent) duty. The Principles provide a voluntary framework by which all investors can incorporate ESG issues into their decision-making and ownership practices and so better align their objectives with those of society at large. We would like to acknowledge the two UK pension schemes that have assisted in the drafting of this response, namely the Environment Agency Pension Fund and RPMI Railpen Investments.

We respond to several of the detailed questions below, but would like to highlight three issues of particular importance first.

1. The meaning of ESG

We note that the Glossary refers to ESG issues as 'ethical, social and governance' factors and we understand that "ethical" was adopted following the similar wording in the Pensions Acts of 2000 and 2005. However, this is not the typical definition used in the market. The general meaning of the acronym is 'environmental, social and governance' and it is these issues which PRI signatories have agreed are long-term risk factors to their investments which should be integrated into investment decision-making[1]. While many signatories do consider ethical issues as critically important and implement these via approaches specific to each investors' particular ethical beliefs, we believe that a switch away from the term 'ethical' would help clarify the definition of ESG issues that can be considered and also clarify the approach that ESG issues are risk factors. This is, for us, a very important distinction. We would also like to add to section 10.64 that it is entirely possible to work to integrate ESG into passive investing, not least through engagement activities. Please refer to our report on activities in this respect.[2]

2. The meaning of fiduciary duty

We welcome the Law Commission's efforts to clarify the meaning of fiduciary duty, and we believe that the report itself may become a reference point for future discussions of the issues. In particular, we note the clarity the report brings to the understanding of *Cowan v Scargill*, that the case does not limit trustees from exercising their judgement about key risks which influence

[1] http://www.unpri.org/viewer/?file=wp-content/uploads/2013-14_PRI_RF_maindefinitions.pdf
[2] www.unpri.org/viewer/?file=files/Passive_case_studies.pdf

investment value over the longer-term. For signatories of the PRI, who have agreed that environmental, social and governance factors are key risks over the length of their investment horizon, this is crucial. In effect, the Law Commission's analysis endorses the integration of ESG factors into investment decisions by those who have made this judgement. Indeed, should such trustees fail to work to integrate these factors they risk being in breach of their fiduciary duties.

3. The breadth of application of fiduciary duty

We welcome the consideration being given to the extent to which fiduciary duties apply throughout the investment chain. We believe that this is a crucial issue and were highly supportive when this matter arose through the Kay Review. We believe that consideration specifically needs to be given to the question of the extent of contracting out fiduciary duties. We believe that this is a real issue that gives rise to significant problems in the real economy and that clarity around this sub-issue would be very helpful for all parties in the investment chain.

Also appended to this response is the January 2014 edition of *RI Quarterly,* a publication by the PRI's Academic Network which summaries key academic and practitioner insights into the global application of fiduciary duty in theory and in practice.

We also direct the Law Commission to our website, in particular the section "introducing responsible investment"[3].

We would welcome further dialogue on these and other issues raised in the consultation if that would be helpful to the Commission. In particular, we have highlighted areas where we believe more clarification and guidance would be helpful, and we would be delighted to assist in the development of this work.

[3] http://www.unpri.org/introducing-responsible-investment/

PENSION TRUSTEES' DUTIES TO ACT IN THE BEST INTERESTS OF BENEFICIARIES

Question 1. Do consultees agree that Chapter 10 represents a correct statement of the current law? (14.6)

Yes we agree and welcome the quality and clarity within the summary of the current legal situation.

We note the quotation from Megarry VC's judgement in *Cowan v Scargill*: "In the case of a power of investment, as in the present case, the power must be exercised so as to yield the best return for the beneficiaries, *judged in relation to the risks of the investments in question*" [our emphasis]. Given that *Cowan* is usually seen as the high-water mark in setting out the view that only financial interests can be considered, this inclusion of risk considerations is highly significant. Signatories of the Principles for Responsible Investment (PRI) have agreed that ESG factors are long-term risk factors in investments; the implication of this is that a failure to properly consider such factors in their investment approach (taking due account of cost implications) may be a breach of institutional investors' fiduciary duties.

We thus wholly agree with the Law Commission's statement in Paragraph 10.55 "Given the evidence that ESG factors can lead to better returns over the longer-term, the answer is clearly that pension trustees may use wider factors. There can be no objection to using ESG factors as a way of increasing long-term performance." And we also firmly agree with this statement from paragraph 10.66 "we think that trustees should consider, in general terms, whether their policy will be to take account of ESG factors in their decision-making, bearing in mind the resources available to them".

We also welcome the comments in the section on ethical considerations to the effect that: "Trustees are entitled to conclude that a firm which is deliberately damaging the environment should be avoided on risk grounds rather than moral ones: it is unlikely to be a sustainable business model in the long term. Similarly a firm which is carrying out human rights violations may present reputational and regulatory risks." While PRI signatories do not tend to use the language of ethics, it is just such ESG risks that they seek to address in their investment approach.

We believe that these comments accurately set out the law of fiduciary duty and we would welcome this elucidation being more broadly communicated, understood and adopted in the investment community, including by financial regulators.

Question 2. Do consultees agree that the law reflects an appropriate understanding of beneficiaries' best interests? (14.11)

Yes, we agree, provided that a full and appropriate consideration of relevant risk factors is built into the trustees' knowledge and understanding of those best financial interests - in the ways discussed above.

Question 3. Do consultees think that the law is sufficiently certain? (14.15)

Yes, and we believe that the Law Commission's analysis helps consolidate and demonstrate the existing certainties.

Question 4. Should the Occupational Pension Scheme (Investment) Regulations 2005 be extended to all trust-based pension schemes? (14.15)

We believe that it is hard to argue that the standards should not apply across the board. Cost can be the only possible argument for the beneficiaries of smaller schemes not enjoying the benefit of their trustees' being obliged to adhere to the Regulations; we believe rather that the standards should apply, and if trustees find that cost factors make this difficult they need to find alternative ways forward to share the cost burdens with their peers and areas of work within the PRI such as Investor Engagements (previously known as the clearinghouse) can facilitate low cost collaborative engagements.

Question 5. Are there any specific areas where the law would benefit from statutory clarification? (14.15)

We are interested to note the inclusion of fees and costs in the investment process as one of the requirements in Australia's Superannuation Industry (Supervision) Act 1993. These are issues of growing focus and attention for UK trustees, and rightly so given the scope for the ongoing erosion of fund value through excessive fee payments. We believe that there may be scope for greater certainty and clarity in this area.

Question 6. Do consultees agree that the law permits a sufficient diversity of strategies? (14.21)

Yes we agree that there is scope under the law for a sufficient diversity of investment strategies. However, perhaps this is not a sufficient answer to the problem: we are concerned that trustees' understanding of the law tends to discourage them from diversity of thought and action. Too often a safety-first culture leads trustees to believe that they are constrained to take advice from a narrow set of advisers and follow a narrow path. Among other things, they believe that this is the best way for them to avoid personal liability.

While we agree that these challenges are largely behavioural ones and arise as much from the natural approach of individuals when facing complexity, we do believe that it is worth considering at least the following four ways in which these behaviours might be interrupted:

- a codification of the law elucidated by the Law Commission such that the current misunderstandings are properly removed;
- a set of guidance for trustees, probably developed by the Pensions Regulator within its trustee toolkit, which delivers the same elucidation such that trustees no longer have a ready basis for misunderstanding the scope of their duties and their implications and that includes the necessary tools to provide sufficient knowledge to trustees on areas such as ESG factors

- changes to the law around the personal liability of trustees such that personal judgement is more clearly supported rather than simply aligning the investments of the pension scheme with those of the broader herd.
- Strengthen the impact of the Statement of Investment Principles (SIP) by encouraging "comply or explain" reporting and actions on ESG considerations. One possibility, as applied in Denmark, would be for this to happen through the PRI's reporting and assessment framework.

We would welcome the Law Commission giving active consideration to the value of these four, and possible other alternative approaches, to the current behavioural issues.

Question 7. Do consultees agree that the main pressures towards short-termism are not caused by the duty to invest in beneficiaries' best interests? (14.24)

We agree, but again this may not be a sufficient response to these issues. The Law Commission again notes the limitations of scale and the associated cost implications; We also note that, as the Law Commission has stated, the Occupational Pension Scheme (Investment) Regulations 2005 apply equally to fund managers for pension schemes as they do to schemes themselves; thus, given that assets should be invested in a manner "appropriate to the nature and duration of the expected future retirement benefits payable under the scheme", fund managers should be obliged to act in a more long term manner than is currently achieved by all.

We agree that there are significant behavioural pressures towards short-termism, but we also note that there are very real regulatory pressures in this same direction. For example, paragraph 10 of The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 requires that the pension funds to which this applies must review the performance of their fund managers at least every 3 months. Given that this is the maximum period between reviews, this represents a very significant pressure towards a short-term approach. We believe that a careful review needs to be carried out to identify any and all such regulatory pressures and to consider whether they are appropriate.

Question 8. Do consultees agree that the law is right to allow trustees to consider ethical issues only in limited circumstances? (14.28)

Yes, we agree, though we note and also agree with the Law Commission's analysis that divestment may be the appropriate step where trustees consider that the failure of an investment to deal appropriately with an ethical issue is likely to have detrimental financial consequences over time. We also note that the typical meaning of the ESG acronym is 'environmental, social and governance' matters, not ethical issues as discussed in the introduction

Question 9. Does the law encourage excessive diversification? (14.32)

Again, this is a matter of interpretation and understanding rather than something the law requires as such. The Trustee Act 2000, s 4(3) (b) requirement to have regard to "the

need for diversification" is clear: a wholly undiversified portfolio would be risky, inappropriate and a clear breach of fiduciary duties. However, even the partly discredited approach of the efficient market hypothesis and its associated theories indicate that the benefits of diversification -- the so-called efficient frontier - can largely be achieved with only limited diversification, of some 20 holdings. This may be a further area where the Law Commission and others might assist trustees and the market to understand that diversification needs to be present but need not be taken to an extreme.

Questions 10 and 11 not answered

Question 12, Overall, do consultees think that the legal obligations on trustees are conducive to investment strategies in the best interests of the ultimate beneficiaries? (14.33)
Question 13. If not, what specifically needs to be changed? (14.33)

As should be clear from the above, we believe that the law is largely fit for purpose but that it is being understood and interpreted in a highly conservative way that is discouraging some actions which would be in beneficiaries' interests. We therefore believe some consideration must be given to assisting building knowledge in this area and a healthier understanding and interpretation of the law.

FIDUCIARY DUTIES IN THE REST OF THE INVESTMENT CHAIN

Question 18. Do consultees agree that the general law of fiduciary duties should not be reformed by statute? (14.61)

We agree that the general law of fiduciary duty should not be reformed by statute; we agree with the Law Commission that there would be inevitable and perhaps unhelpful complexities introduced were statute to be applied to an area of flexible common law.

However, we do not agree that this is a strong argument against the principal point identified by Professor Kay: that it should not be possible in effect to exclude fiduciary duties by contract. Steps to remove the opportunity to -- as some respondents to the Kay Review put it -- contract out of fiduciary duty would not of themselves require a codification of exactly what is meant by fiduciary duty and so should not give rise to the problems that the Law Commission identifies. We believe that steps in this direction should be actively pursued.

Question 19. Should rights to sue for breach of statutory duty under section 138D of the Financial Markets and Services Act 2000 be extended? (14.67)

Given that we favour steps to clarify that it should not be possible to contract out of fiduciary duty, we do not believe that this possible approach should be favoured.

Question 20. Is there a need to review the regulation of investment consultants? (14.71)

We would welcome such a review.

Question 21. Is there a need to review the law of intermediated shareholdings? (14.74)

We would welcome such a review.

Question 22. Should the FCA review the regulation of stock lending by custodians? (14.75)

We would welcome such a review. At very least, there is a need for a great deal more clarity about stock lending activities: at present too much of this occurs in the background and the beneficial owners of the assets may not be aware as to the extent.

Do you have any other comments about fiduciary duties in the investment chain, or how those duties are applied in practice?

Voting in pooled funds
Further to comments on 3.79 on trustees being less involved in stewardship, one possible obstacle is where they are unable to have a say in how votes are cast in respect to underlying shareholdings in pooled fund investment vehicles, with some pooled funds not allowing clients to issue pro rata voting instructions. This means that the asset owners whose assets are held within such vehicles are unable to vote their shares in accordance with their specific wishes and often have to wait some time to find out how their votes were used. If an asset manager is unwilling to entertain any dialogue on voting in relation to the wishes of the client in advance of a specific vote or company meeting, and is only prepared to report on a post hoc basis long after the vote in question, this can effectively disenfranchise even large asset owner clients. It is not clear to us how this promotes good stewardship.

We would be interested in the Law Commission, or other parties, reviewing whether there are regulatory or other legal barriers to pooled funds facilitating pro rata voting.