The Enlightened Shareholder

Clarifying investors' fiduciary duties

FairPensions™

The campaign for **responsible** investment

About FairPensions

FairPensions (Fairshare Educational Foundation) is a registered charity established to promote responsible investment practices by pension providers and fund managers. FairPensions champions greater transparency and accountability to the millions of people whose long-term savings are managed by institutional investors and other professional agents. FairPensions believes that responsible investment helps to safeguard investments as well as securing environmental and social benefits.

We are supported financially by a number of leading charitable foundations and count amongst our member organisations a growing number of globally recognised NGOs and trade unions. Over 8000 individuals support our work both by taking action directly to advance responsible investment and through personal donations.

Further information about us can be found at www.fairpensions.org.uk.

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1. Introduction

Institutional investors are powerful economic actors on whom millions of savers depend. With the advent of automatic enrolment, up to eight million more UK workers will become directly dependent on the capital markets for their wellbeing in retirement.[1] Meanwhile, pension funds' role as owners of UK plc is coming under increasing scrutiny, following criticism that investors acted as 'absentee landlords' in the run-up to the financial crisis and have failed to control spiralling executive pay. They are also increasingly being turned to as providers of the productive investment needed to get the UK economy moving, whether in green infrastructure or SMEs.

> *Fiduciary obligations exist to ensure that those who manage other people's money act responsibly in the interests of savers, rather than serving their own interests.*

It is therefore vital that the law supports rather than impedes long-term, responsible investment of pension savings. This single policy lever has enormous implications for our ability to meet today's key policy challenges: demographic, economic and environmental.

Fiduciary obligations exist to ensure that those who manage other people's money act responsibly in the interests of savers, rather than serving their own interests. Yet interpretations of this crucial legal principle appear increasingly dysfunctional. On the one hand, returns to savers are stagnating while fees paid to intermediaries continue to rise[2] and conflicts of interest proliferate.[3] On the other, 'fiduciary duty' is frequently invoked to justify behaviour that could actually damage savers in the long term - such as neglect of ownership responsibilities and of sustainability factors.

The shift to defined contribution (DC) pensions greatly increases the potential for this dysfunctionality to cause consumer detriment. There is therefore an urgent need to reclaim fiduciary duty from the prevailing fixation on maximising short-term returns and to refocus it on sustainable wealth creation.

FairPensions' 2011 report, *'Protecting our Best Interests: Rediscovering Fiduciary Obligation'*,[4] examined fiduciary duty as a barrier to long-term sustainable investment. It concluded that the narrow interpretations which have become standard do not reflect the underlying legal principles: fiduciary duty does not so much need to be reformed as rediscovered. The report recommended statutory clarification of the scope of investors' duties, placing this in the context of the Companies Act 2006, which aimed to enshrine a more enlightened interpretation of directors' duties. This paper explores and refines that recommendation.

A roundtable discussion was held on 19 October 2011 with experts from industry, academia and civil society. (A full list of attendees is included at Appendix B.) Participants generally agreed that there would be value in pursuing our recommendation for statutory clarification. They also provided helpful input on various questions of detail, such as to whom such a provision should apply, the definition of key terms, and the range of factors to which investors should be enabled to 'have regard'. We are extremely grateful for this input which has directly informed the proposals set out in this paper.

> *There is an urgent need to reclaim fiduciary duty from the prevailing fixation on maximising short-term returns and to refocus it on sustainable wealth creation.*

2. What is the problem?

2.1 The 'duty to maximise returns'
Fiduciary investors do not have one single 'fiduciary duty' but a number of distinct duties - for example, to treat all beneficiaries impartially and to avoid conflicts of interest. Yet fiduciary duty is routinely equated with a single, over-riding 'duty to maximise returns.' This can be traced to a particular reading of Cowan v Scargill - the most commonly-cited case in this area - which said that *"when the purpose of the trust is to provide financial benefits ... the best interests of the beneficiaries are* normally *their best financial interests"* (our emphasis), and that powers of investment *"must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risks."*[5]

There are two problems with the prevailing interpretation of this principle:

1. 'Return' is itself often interpreted narrowly as an exclusive focus on share price and dividends, rather than encompassing underlying fundamentals and systemic factors that influence long-term outcomes for savers.
2. It assumes that fiduciaries are absolutely barred from considering factors other than financial return, even if financial interests are given clear priority. This is a misreading of Cowan v Scargill, which explicitly confirms that *"'benefit' is a word with a very wide meaning."*[6]

The practical implications of this are significant. Firstly, it contributes to a **neglect of factors which are not immediately monetisable**, such as environmental, social and governance (ESG) risks or engagement activity. Paradoxically, this is unlikely to achieve optimal financial outcomes for beneficiaries over the long term (or even, in some cases, the short term). Following the landmark Freshfields report,[7] many large pension funds now accept that ESG issues can affect returns - with the consequences of the Gulf of Mexico oil spill for BP perhaps the starkest recent example. Likewise, growing take-up of the Stewardship Code reflects increasing acceptance that the exercise of ownership rights to ensure companies are well-governed can improve long-term performance. Yet the 'fiduciary duty to maximise return' is still frequently invoked - particularly among smaller schemes - as a barrier both to engagement and to integration of ESG issues.

> It is not the duty of trustees simply to maximise short-term returns
>
> ***Steve Webb***

This in turn compounds the problem of **short-termism** in investment decision-making. The idea that trustees' duties begin and end with maximising returns, combined with the desire to ensure that duty is fulfilled by regularly holding fund managers to account for their performance, contributes to a focus on quarterly results and pressure for short-term outperformance. As recent academic work has demonstrated,[8] this may not in fact optimise long-term performance. Meanwhile, risks and opportunities which do not have a demonstrable and immediate financial impact are treated as outside the scope of fiduciary duty.

We are not suggesting that fiduciary duty is the only driver of short-termism: pension schemes face many practical and regulatory challenges, the nature of which is changing with the shift from defined benefit (DB) to defined contribution (DC). However, in common with organisations like Hermes, the Co-operative Asset Management, Tomorrow's Company and the Foundation for Governance Research & Education, we believe that fiduciary duty is an important part of the picture and one which merits close attention.

Narrow interpretations of 'financial interests' also neglect factors affecting beneficiaries' **broader economic wellbeing**. For example, UK pension savers have an obvious interest in the stability and strength of the UK economy, yet under prevailing interpretations of the law this cannot form part of the equation: trustees must simply seek the best risk-adjusted returns wherever and however these are to be achieved. Yet the performance of the economy as a whole will ultimately be a far greater determinant of the size of the average saver's pension pot than the extent to which their fund outperforms the market. This approach also forgets that pension investments do not exist in a vacuum: they are not an end in themselves, but a means to securing a decent retirement. Pension savers' interests may not be optimised by the maximum possible pension pot, if this is achieved through investments which reduce that pot's spending power (for example, by contributing to higher food and fuel prices).

Likewise, this interpretation also rules out any consideration of the impact of investments on beneficiaries' broader **quality of life** - for example, the implications of extreme weather caused by irreversible climate change, or, where beneficiaries are not geographically dispersed, the impacts (positive or negative) of investments on their local communities. There are examples of pension funds taking these broader issues into account - reinforcing the case that it is not incompatible with existing law - but they are very much the exception rather than the rule. This is not to suggest that fiduciaries can or should take sole responsibility for societal or environmental problems. Rather, the danger is that the prevailing narrow view may lead to decisions which are optimal on their own terms, but ultimately suboptimal for beneficiaries' wellbeing.

> We want our pensioners to retire into a similar environment than we enjoy today and not one that is affected by the extremes of climate change that could reduce their life expectancy
>
> ***Howard Pearce, Environment Agency Pension Fund***

The assumption that only financial interests are relevant to fiduciaries has also led to a perception that **ethical investment and social impact investing** are entirely off-limits for pension funds. Again, this is not supported by case law. Indeed, the judge in Cowan v Scargill subsequently made it clear that the case did not prevent trustees from considering beneficiaries' ethical views when choosing between investments of equal merit (the 'ethical tie-break').[9] Government Ministers have confirmed that pension schemes may take ethical issues into account - including former Pensions Minister Lord McKenzie (*"there is no reason in law why trustees cannot consider social and moral criteria in addition to their usual criteria of financial returns, security and diversification"*[10]) and current Pensions Minister Steve Webb (*"a socially responsible investment strategy is a sound choice for pension schemes"*[11]). Yet this seems to have largely failed to shift perceptions, with funds still routinely stating that their fiduciary obligations absolutely prohibit them from excluding companies on ethical grounds.[12]

> ***pension investments do not exist in a vacuum: they are not an end in themselves, but a means to securing a decent retirement.***

2.2 The 'duty to herd'

A second problem with prevailing interpretations of fiduciary duty is what US academic Keith Johnson has called the 'lemming standard'.[13] The duty to invest prudently is understood by reference to the behaviour of other investors: fiduciaries must *"take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide"*.[14] Likewise, the classic US statement of this duty requires fiduciaries to *"observe how men of prudence, discretion and intelligence manage their own affairs."*[15] This may make trustees fearful of departing from established investment orthodoxy and make the industry as a whole slow to evolve.

For example, it has been suggested that this in-built conservatism may have contributed to the industry's slow progress in factoring climate change and sustainability into its investment models.[16] Conversely, it may help to entrench prevailing norms - such as quarterly monitoring of performance against a benchmark - even when they are widely acknowledged to be destructive. As one recent academic paper puts it, *"In circumstances such as the present, where investors are typically driven by short-term performance, prudent investment becomes short-term investment."*[17] Pension funds may not wish to 'jump first' and adopt innovative strategies that are out of step with their peers, since this could leave them exposed to charges of imprudence.

> ***"the law should clearly retain the flexibility for trustees to exercise independent judgement when they believe the market is behaving irrationally"***

This interpretation of prudence may also contribute to an excessive focus on benchmark-relative performance, even at the expense of the ultimate goal of creating long-term value for beneficiaries. In the inimitable words of Lord Myners, *"People's pensions are not paid by relative performance but absolute performance, yet this industry is obsessed with relative performance ... In this world, it is fine to be wrong or even lose money, as long as you do so in the company of others."*[18] While such a standard may have made sense 200 years ago, when the prudent investor rule was first developed, it fails to take account of the role of pension funds as market participants, and of our growing understanding of how herding behaviour contributes to bubbles and crashes, creating market volatility that can be hugely damaging for savers. For example, if a pension fund's equity manager had seen the dotcom bubble for what it was and refused to invest in tech stocks in the build up to 2001, would it really have been 'prudent' for the fund to sack the manager for under-performing the benchmark? This is far from a hypothetical scenario, as numerous asset managers can testify.

> "In circumstances such as the present, where investors are typically driven by short-term performance, prudent investment becomes short-term investment."
>
> ***Claire Woods***

The lack of recent case law makes it difficult to say how a court would interpret such a case today. On the one hand, the duty of prudence is effectively a 'reasonable man standard', and is therefore necessarily relative to some extent. On the other, the law should clearly retain the flexibility for trustees to exercise independent judgement when they believe the market is behaving irrationally. Indeed, the English courts have stated that the prudent man standard is *"an extremely flexible standard capable of adaptation to... contemporary understanding of markets and investments"*.[19] Just as the duty of prudence evolved in the twentieth century to take account of modern portfolio theory (for example, through the duty to diversify),[20] so it needs to evolve in the twenty-first to take account of the ways in which investors' behaviour as market participants can affect outcomes for their beneficiaries.

2.3 'Enlightened shareholder value': An orphaned concept

Narrow interpretations of fiduciary obligation are also holding back efforts to promote more long-termist, responsible behaviour at company level. Section 172 of the Companies Act 2006, which sets out directors' duties, was designed to achieve precisely this objective. Its stated aim was to *"embed in statute the concept of Enlightened Shareholder Value by making clear that directors must promote the success of the company for the benefit of its shareholders, and*

> [We will] embed in statute the concept of Enlightened Shareholder Value by making clear that directors must promote the success of the company for the benefit of its shareholders, and this can only be achieved by taking due account of both the long-term and short-term, and wider factors such as employees, effects on the environment, suppliers and customers.
>
> ***Company Law Reform White Paper 2005***

this can only be achieved by taking due account of both the long-term and short-term, and wider factors such as employees, effects on the environment, suppliers and customers."[21] Section 172 therefore requires directors to 'have regard' to these long-term and wider factors (see Appendix C).

However, five years on, the success of this provision in promoting a broader and more enlightened approach is unclear. For example, a recent study for the Association of Chartered Certified Accountants (ACCA) found that section 172 has had little impact either on directors' behaviour or on the way they regard their legal obligations.[22] This seems to be particularly the case in hostile takeover situations, where directors presume that the 'underlying' duty to secure the best price for current shareholders trumps the wider factors listed in section 172.

> The majority of companies, in particular smaller companies, say they have noted relatively little change in approach to engagement … some shareholders still seemed to focus too much on specific issues of a short term nature
>
> ***FRC, 2011***

In the context of perceptions about investors' fiduciary obligations, this is perhaps not surprising. Put simply, 'enlightened shareholder value' relies on the presence of enlightened shareholders. The basic duty of directors is still to promote the success of the company in the interests of its members, namely the shareholders (in contrast to the more radical 'stakeholder' approach which some argued for during the Company Law Review). If fiduciary shareholders interpret their own duty to their beneficiaries as the maximisation of short-term return, it is hardly surprising that this imperative will be transmitted up the chain to directors, overriding section 172's 'nudge' towards a more enlightened approach. And indeed, that is exactly what directors themselves report.[23] Echoing the ACCA study's findings, a recent FRC report noted that most companies said that they *"[had] noticed relatively little change in approach to engagement"* and that *"some shareholders still seemed to focus too much on specific issues of a short term nature."*[24]

> ***'enlightened shareholder value' relies on the presence of enlightened shareholders***

Prevailing interpretations of fiduciary duty work directly against the aims of section 172: many trustees appear to believe that the law obliges them to be 'unenlightened', disregarding all wider factors in favour of the single objective of maximising returns. Section 172's limited impact on behaviour may therefore be a direct consequence of the fact that it deals with company directors in isolation from company owners.

3. What is the solution?

The problem of unduly narrow and short-termist interpretations of investors' fiduciary duties precisely parallels the problem with interpretations of directors' duties which section 172 was designed to solve. It is our belief that these two problems can only ever be solved together, and that there is therefore a need to revisit section 172 and consider a parallel provision for institutional investors themselves. The aim of statutory clarification would be to put beyond doubt that investors may have regard to a wider range of factors than is currently assumed, freeing trustees to exercise their judgement and common sense about what will serve their beneficiaries' interests rather than feeling obliged by law to take a narrow view.

3.1 Why legislative change?

We do not believe that legislative change is a 'silver bullet' which will translate automatically into behavioural change. Rather, this is a specific proposal designed to deal with a specific problem: namely, that dysfunctional and inaccurate interpretations of investors' legal obligations are acting as a *barrier* to behaviour change. Since this is a problem with interpretation of the law, it seems unlikely to be resolved without explicit clarification of the law.

> ***"Since this is a problem with interpretation of the law, it seems unlikely to be resolved without explicit clarification of the law."***

Indeed, many 'softer' methods have already been tried, but lack the reach, status and legal authority of explicit statutory clarification. Their impact on understandings of the law, and by extension on behaviour, has therefore been generally limited.

- Since 2000, regulations have required pension scheme trustees to disclose, in their statements of investment principles, their policy on the extent (if at all) to which social, environmental or ethical considerations are taken into account.[25] These regulations were intended as a 'light-touch' intervention to confirm that it was legal for pension funds to consider these factors.[26] However, in the absence of explicit confirmation, this does not appear to have had the desired impact: many funds publish 'boiler-plate' disclosures to the effect that they take social and environmental issues into account only insofar as is consistent with their fiduciary duty to maximise return.

- Government statements such as that by Lord McKenzie that *"there is no reason in law why trustees cannot consider social and moral criteria"*[27], or by Steve Webb that *"it is not the duty of trustees simply to maximise short-term returns"*,[28] although helpful, lack the reach and status of statutory clarification and have not brought about a sea-change in prevailing interpretations of the law.

- Non-government initiatives, such as the landmark Freshfields Report,[29] have been influential in shaping the debate about fiduciary obligation. However, they have no official legal status and so offer little comfort to trustees who fear liability if they depart from established norms. Six years on from the Freshfields Report, there are still many who either reject its conclusions, or are simply unaware of them.

Indeed, 'softer' initiatives are themselves often held back by narrow interpretations of the law. The disclosure regulations are one example: the regulations themselves are generally assumed to be subordinate to trustees' over-riding fiduciary duty to maximise returns, which has limited their impact.

3.2 What will this proposal achieve?

The aim of this proposal is not to impose behavioural or cultural change by regulatory fiat. Rather, it aims to clarify the legal position and to create an enabling environment in which initiatives to shift behaviour are not held back by myths and narrow interpretations of investors' room for manoeuvre.

The anticipated effects of statutory clarification would be:

- to give comfort to investors that genuinely wish to take a more enlightened approach, but fear that this could leave them in breach of their fiduciary duties;
- to remove a convenient 'smokescreen' from those who do not wish to take such an approach, encouraging such decisions to be justified on their own merits and not simply by reference to fiduciary duty; and
- to help overcome the collective action problem created by the 'duty to herd', 'nudging' the market in a more long-termist and responsible direction.

3.3 Would this add to the regulatory burden on trustees?

No. Our proposed legislation is framed in a permissive way ('may' rather than 'must') in line with its objective of freeing trustees to exercise their independent judgement. Moreover, we do not believe that these proposals in general mark a significant departure from existing common law principles: the main intention is simply to clarify the law in areas where it is either ambiguous or persistently misunderstood.

> *"the impact assessment for section 172 of the Companies Act 2006 found that there were 'no obvious costs' and an estimated benefit of £30m - £105m per annum"*

It is also worth noting that the impact assessment for section 172 of the Companies Act 2006, on which this proposal is based, found that there were 'no obvious costs' and an estimated benefit of £30m - £105m per annum.[30] Indeed, by adding the missing piece of the puzzle - the enlightened shareholders - these proposals could arguably help ensure that those predicted benefits are realised.

4. The enlightened shareholder: an 'investor equivalent' of section 172

4.1 Scope

The first question facing any attempt to replicate section 172 for investors is to whom it should apply. Participants at our roundtable were in clear agreement that the scope of any such provision should not be restricted to pension fund trustees, but should apply consistently to all those exercising discretion over pension fund assets, regardless of the legal form of those arrangements (i.e. trust or contract-based). In this they echoed Steve Webb's comments during the Committee Stage of the Pensions Bill, when an early draft of our proposal was debated through a probing amendment:

"One of our reservations would be that it would only apply to occupational pension funds - which is what the Bill is about - and not to other sorts of investors, such as insurance companies that provide pensions, which could create an unevenness... I will be careful that any solutions that we find do not put conditions that are not imposed on other investment vehicles on pension schemes."[31]

We therefore suggest that any new provision should apply as a minimum to pension fund trustees, the investment managers to whom they delegate, and commercial pension providers such as insurance companies. This is reflected in our proposed draft legislation. Given their crucial role in advising pension funds on key decisions, and the significant influence which this role entails,[32] investment consultants have also been included within the scope of the draft legislation.

However, the Minister's comment raises a wider question. There is already *"unevenness"* between the obligations of trust- and contract-based providers, since the latter are generally assumed not to have fiduciary obligations. Given that the primary purpose of an 'enlightened investor' provision is to remove the perceived legal barriers associated with fiduciary duties, the call for consistency may suggest a case for tackling these underlying discrepancies. These issues will be considered at two further roundtables in April 2012, the conclusions of which will complement and build on the contents of this paper. Pending this further examination, this aspect of the draft legislation is necessarily somewhat tentative.

> ***"the scope of any such provision should not be restricted to pension fund trustees, but should apply consistently to all those exercising discretion over pension fund assets"***

As regards implementation, we recognise that in practice, parallel provisions might well be required for the different actors covered, each amending the existing regulations applying to those actors.[33] For the sake of simplicity, our draft legislation adopts a 'one-size-fits-all' approach, with section 2 detailing the actors to whom it applies.

4.2 Factors to which fiduciaries may 'have regard'

Section 1(1) of the draft legislation begins by restating basic fiduciary principles: that investors must act in the best interests of their beneficiaries, and impartially between beneficiaries. This can be likened to directors' basic duty to *"promote the success of the company for the benefit of its members as a whole"*, and in doing so to have regard to the need to act fairly as between members of the company, both outlined in section 172 of the Companies Act 2006.

Subsection (1) goes on to list the factors to which investors may have regard in discharging these duties. Unlike the first part of the subsection, this list is framed in a permissive way ('may' rather than 'must'). This makes clear that the purpose of the legislation is to put beyond doubt that investors may legitimately consider the factors listed, rather than to impose a new set of prescriptive compliance requirements. The draft legislation makes clear that the list is not exhaustive and is in no way intended to restrict investors' room for manoeuvre - indeed, quite the opposite.

We do not believe that any of these factors contradict existing case law or mark a significant departure from existing legal principles. In most cases, they extrapolate and clarify issues on which there is little or no case law - for example, the integration of environmental, social and governance (ESG) issues - rather than attempting either to codify or to override existing judicial decisions.

Below we outline the factors listed and explain the rationale behind each of them. In some cases these factors directly parallel those in section 172 of the Companies Act 2006; in others, the issues affecting investors differ from those affecting company directors (see comparison chart below).

(a) the likely consequences of any investment activities in the long term

This aims to overcome the assumption that, if fiduciaries cannot demonstrate that they are maximising performance on a quarterly basis, they may leave themselves legally exposed for breach of their fiduciary duties. The interests of pension savers are inherently long term, yet narrow interpretations of fiduciary duty run the risk of exacerbating short-termism. The intent of this subsection is to help give trustees and other fiduciary investors comfort that they will not be penalised for taking a long view.

(b) the impact of any investment activities on the financial system and the economy

Together with (a) above, this aims to provide investors with a defence against the perceived 'duty to herd', outlined in section 2.2. It clarifies that investors' duty of prudence does not necessarily require them to follow conventional market practice if this might harm the long-term interests of the fund (subsection (a)) or contribute

Section 172, Companies Act 2006	Proposed 'enlightened shareholder' provision
(a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationships with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company.	(a) the likely consequences of any investment activities in the long term, (b) the impact of any investment activities on the financial system and the economy, (c) social and environmental considerations, including (i) the implications of environmental and social factors for return on investments, and (ii) the impact of any investment activities on communities and the environment, (d) the implications of any investment activities for beneficiaries' quality of life, and (e) the views, including the ethical views, of beneficiaries.

to market volatility and financial instability which could hurt their members (subsection (b)). Possible applications of this principle include giving fund managers licence to avoid fuelling a bubble even if this results in short-term under-performance, and limiting portfolio turnover if the fiduciary believes that excessive churn is not in their beneficiaries' interests.

The reference to the impact of investment activities on the economy seeks to clarify that investors can have regard to the wider macroeconomic context in which value for beneficiaries is generated, and to their impact - positive or negative - on the performance of the economy. For example, during a recession, funds may feel that the best way to serve their beneficiaries' interests is to invest a portion of their capital in job-creating enterprises in order to help boost local or national economic growth. Strathclyde Pension Fund's £100m 'New Opportunities Fund'[34] which invests in job creation in Glasgow, offers an example of such an approach.

(c) environmental and social issues, including

(i) the implications of environmental and social factors for long-term return on investment, and

(ii) the impact of any investment activities on communities or the environment.

As discussed in section 2.1, despite increasing acceptance that environmental and social issues can be material to investment return, there remains a lingering perception in some quarters that fiduciary duty is a barrier to consideration of these issues. The first half of this paragraph intends to put beyond doubt that investors can consider financially material environmental and social issues.

The second half directly parallels the equivalent provision in section 172 of the Companies Act. It intends to clarify that investors can also consider the wider impacts of their investment activities on society or the environment - i.e. that the law does not prohibit them from acting as 'good citizens'. This would be subject to the clause defining 'benefit' (see section 4.4), which makes clear that purely non-financial considerations cannot be placed ahead of the need to secure financial return.

(d) the implications of any investment activities for beneficiaries' quality of life

This intends to clarify that investors are not obliged to make decisions which may drastically compromise beneficiaries' quality of life simply because they are expected to deliver a marginally better financial return than the alternative.

As an example, one participant in the roundtable recounted that they had sought legal advice on whether, when voting on a hostile takeover, their fund could have regard to the fact that some of their beneficiaries might lose their jobs. The response was that they could not take this into consideration: their fiduciary duty required them to make their decision based solely on the price they would be paid for selling their shares. This provision should prevent this counter-intuitive result and ensure that investors have the discretion to consider all relevant factors. Like all investment decisions, this would of course be subject to the general duty of impartiality. Investors would need to consider whether the impact on particular beneficiaries' quality of life outweighed the potential effect on financial returns for other beneficiaries who were not affected.

This would also give investors the discretion to consider the impact of their decisions on other aspects of their beneficiaries' lives - both positive (for example, through investment in their local community) and negative (for example, the potential impact on their retirement security of irreversible climate change).

(e) the views, including the ethical views, of beneficiaries.

This intends to overcome the assumption that Cowan v Scargill prevents investors from considering ethical issues when making investment decisions.

Again, this would be subject to the definition of 'benefit' outlined in section 4.4, so it is clear that ethical considerations could not trump the requirement to secure a decent financial return. However, decisions could be made on ethical grounds if this would not compromise financial return (the 'ethical tie-break'). It also makes clear that any decisions made on ethical grounds would need to be rooted in the fiduciary's assessment of *beneficiaries*' ethical views, and not the fiduciary's own personal views.

> ***"in a world where beneficiaries increasingly take the risk on their own investments, their traditionally passive role in the fiduciary relationship may no longer be appropriate"***

This would also be relevant to DC pension schemes which offer members a choice of funds, where members may wish to invest in line with their ethical preferences even if this means lower returns. Research by the DWP[35] suggests that around 25% of savers may fall into this category, yet many DC schemes still do not offer their members an ethical option. Those that do often offer products that are heavily screened and may offer poor returns whilst not reflecting beneficiaries' values. Funds that have attempted to survey their members' ethical preferences, such as NEST and The Pensions Trust, have tended to find that their biggest concerns are environmental issues and labour rights,[36] yet these priorities are not necessarily reflected in the products available - which often screen out 'sin stocks' such as alcohol and gambling.

This subsection is not limited to ethical views, but is deliberately broad to allow the consideration of beneficiaries' views on other aspects of investment policy. This reflects the growing recognition that, in a world where beneficiaries increasingly take the risk on their own investments, their traditionally passive role in the fiduciary relationship may no longer be appropriate. It also reflects the fact that pension fund beneficiaries, unlike those of most private trusts, effectively provide the money to be invested (whether through direct contributions or through employer contributions which are essentially deferred remuneration).

It is important to note that this would only provide that fiduciaries may have regard to beneficiaries' views: it would not in any way compromise the principle that fiduciaries are solely responsible for their own decisions, nor alter the fiduciary relationship of reliance by beneficiaries on those decisions. For example, if beneficiaries expressed strong views on social or ethical matters, it would be for the fiduciary to decide whether or how those views could be integrated into investment and engagement policies.

4.3 'Standards of conduct'

"If a fiduciary considers that the general adoption by market participants of a particular standard of conduct has been or would be conducive to the benefit of the beneficiaries, the fiduciary may observe and promote the standard notwithstanding any rule of common law or equity which might otherwise oblige the fiduciary to act contrary to the standard or to require or influence any other person to do so."

Section 172 of the Companies Act requires directors to have regard to *"the desirability of the company maintaining a reputation for high standards of business conduct"*.[37] This provision is not replicated in our list of matters to which investors may have regard, since roundtable participants felt that it did not translate directly into an investment context.

> *Whether or not the 'duty to gazump' is still appropriate for private trusts, it is indefensible for it to apply to major market participants.*

However, the underlying issue addressed by this provision is highly relevant in the context of investors' fiduciary duties. The judgement in Cowan v Scargill endorsed the principle that *"trustees may even have to act dishonourably (though not illegally) if the interests of their beneficiaries require it."*[38] This reflected an earlier judgement which held that trustees were obliged to 'gazump' if it was in their beneficiaries' interests.[39] This is clearly at odds with a corporate governance regime that seeks to encourage companies and investors alike to behave in an enlightened manner.

Our draft legislation therefore authorises fiduciaries to behave as 'good citizens' by clarifying that they are not obliged to adopt lower standards of conduct than those which have been adopted, or which they believe should be adopted, by the market as a whole. This stand-alone provision (in section 1(2) of the draft legislation) does mark a substantive departure from existing case law. Whether or not the 'duty to gazump' is still appropriate for private trusts, it is indefensible for it to apply to major market participants. In this respect, the objectives of this section are similar to those of fiduciary-like provisions in countries such as Germany and Italy, which require investors to act in the interests of their beneficiaries *"and the integrity of the market"*.[40] However, our approach is fundamentally different in one crucial respect: it only applies if the fiduciary considers that the general adoption of a given standard of conduct would be *"conducive to the benefit of the beneficiaries"*. Like the rest of the draft legislation, it therefore preserves the principle that a fiduciary's duties are owed exclusively to the beneficiaries.

> "Trustees may even have to act dishonourably (though not illegally) if the interests of their beneficiaries require it.
>
> ***Cowan v Scargill***

The reference to the fiduciary 'requiring or influencing other persons' to act contrary to a given standard of conduct is intended to cover mandates to investment managers and engagement with investee companies.

The expression *'standard of conduct'* is defined in section 1(3). The definition includes standards relating to ESG matters that are set out in international conventions or voluntary codes of practice. Examples might include the UNPRI, the UK Stewardship Code, or the Universal Declaration of Human Rights. To be clear, this provision would not *require* fiduciaries to comply with any particular standard of conduct. Rather, it aims to overcome the collective action problem created by a 'lowest common denominator' view of fiduciary duty which requires fiduciaries to act contrary to widely-accepted social and moral norms. Combined with the endorsement of collective action with other market participants (see section 4.5(i) below), this would empower fiduciaries to promote their beneficiaries' interests in a more enlightened and effective way.

4.4 Defining 'benefit'

"benefit" includes -

(a) financial benefit provided out of investments; and

(b) any benefit which the fiduciary considers can be conferred on beneficiaries without any material prejudice to long-term return on investments.

The core duty of a fiduciary is to act in the best interests of their beneficiaries. The key distinction here is whether the fiduciary is promoting the beneficiaries' benefit, or unlawfully pursuing their own benefit or that of a third party. Yet in debates about investors' duties, this is often conflated with the separate distinction between financial and non-financial benefit. Contrary to popular belief, case law does not require fiduciaries to restrict themselves solely to promoting beneficiaries' financial benefit and to ignore all wider considerations. Indeed, the judge in Cowan v Scargill was at pains to clarify that *"I am not asserting that the benefit of the beneficiaries which a trustee must make his paramount concern inevitably and solely means their financial benefit."*[41]

> "I am not asserting that the benefit of the beneficiaries which a trustee must make his paramount concern inevitably and solely means their financial benefit."
>
> *Cowan v Scargill*

Of course, as the judge also noted, fiduciaries must act in line with the purposes of their trust. Where its purpose is to provide a pension, their primary consideration must be the provision of financial benefits. But this is not the same as saying that this must be their only consideration. Indeed, it is worth asking: if the purpose of a trust is to provide a pension, what is the purpose of the pension? A pension is not an end in itself but a means to the end of a secure and prosperous retirement. Case law has confirmed that charitable trustees overseeing investments, whilst having a primary duty to produce returns for the charity, can also take account of the effect their investments may have on the charity's *underlying* purpose - so, for example, an anti-smoking charity would not be obliged to invest in tobacco simply because it produced the best return. Yet in a pensions context, it is generally assumed that fiduciaries would be obliged to make a decision which compromised their beneficiaries' wellbeing, now or in retirement, if this decision were expected to produce even a marginally higher return. The example given earlier, of a fund voting on a takeover in which some of their beneficiaries would lose their jobs, illustrates the implications of this approach.

The draft legislation aims to confirm that the law gives fiduciaries more latitude in this area than is commonly assumed. It states that fiduciaries may consider *"any benefit which the fiduciary considers can be conferred on beneficiaries without any material prejudice to long-term return on investments"*. As already indicated, the factors to which fiduciaries may 'have regard' are all subject to this definition of benefit. In this way, the proposed legislation does not create a proliferation of competing considerations with no way of choosing between them, or give fiduciaries carte blanche to pursue their own agendas to the detriment of returns to beneficiaries. Rather, it preserves the primary purpose of investment - i.e. delivering financial benefits - authorising fiduciaries to consider wider factors only insofar as they do not compromise this primary purpose. This is consistent with the existing principle of the 'ethical tie-break' (see sections 2.2 and 4.2).

The drafting here is deliberately broad and does not prescribe the kind of benefits which fiduciaries may consider. This is to avoid inadvertently limiting fiduciaries' discretion and to encompass, for example, beneficiaries' broader economic wellbeing or quality of life. Likewise, there is no attempt to prescribe what might or might not constitute 'material prejudice' to long-term investment return: that is a question properly left to the fiduciary's discretion.

4.5 Defining 'investment functions'

The draft legislation outlined so far relates to how a fiduciary may exercise their *"investment functions"*. This expression is subsequently defined in section 1(3). Some elements of the definition merit further exploration, and so a commentary is provided below.

(a) the selection, retention and realisation of investments,

This is self-explanatory and is drawn from the wording used in existing pensions regulations.[42]

(b) the exercise of rights, including voting rights, attaching to investments,

(c) engagement with the managers of investee companies and other investee entities, including in relation to corporate governance and corporate actions,

As discussed in section 2.2, fiduciary duty is sometimes seen as precluding the exercise of ownership rights. This has been identified as a key barrier to the success of the stewardship agenda by various organisations including Tomorrow's Company[43] and the Foundation for Governance Research and Education.[44]

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It has been suggested that this perceived barrier could be overcome by introducing a new 'fiduciary duty of stewardship'. We believe that the approach taken by this draft legislation is more consistent with existing fiduciary principles. It clarifies that ownership rights are among the powers which fiduciaries should exercise in the interests of their beneficiaries, and that those interests may include the promotion of sustainable wealth creation. It also makes clear that stewardship is not a type of investment akin to SRI, still less one that conflicts with fiduciaries' legal duties, but rather that engagement is one of the tools entrusted to them to use on beneficiaries' behalf. This should help to overcome the *"confusion as to what is meant by 'stewardship'"*[45] which was recently identified by the FRC as a barrier to take-up of the Stewardship Code.

> "There is some confusion as to what is meant by "stewardship", with some equating it solely with socially responsible investment. The FRC believes that greater clarity on this point would be desirable."
>
> ***FRC, 2011***

Paragraph (b), which deals with voting rights, is drawn from the wording used in existing pensions regulations.[46] Paragraph (c) is intended to clarify that engagement may go beyond the exercise of voting rights, and to draw particular attention to investors' role in the UK corporate governance framework. The reference to 'corporate actions' is intended to make clear that the principles contained in the draft legislation can be applied to takeovers and other transactions.

(d) the selection, appointment and monitoring of investment managers and other agents to whom the fiduciary delegates any investment functions,

(e) the selection, appointment and monitoring of investment consultants and of other advisers in relation to the performance of any investment functions,

This provision clarifies a key fiduciary function of asset owners in today's complex investment chains. Since asset owners will usually not be making day-to-day investment decisions, they will apply these principles primarily through their selection of fund managers, development of mandates and ongoing monitoring of their agents' activities. In particular, encouraging asset owners to embed enlightened fiduciary principles into their mandates will help to align interests through the investment chain with the long-term interests of beneficiaries.

(f) the selection and ongoing review of any investment funds which are operated by institutions acting as principals and in which the fiduciary invests,

This covers the selection of funds, including default funds, in defined contribution schemes. It also covers the selection of funds offered by insurance companies providing group and individual personal pensions.

(g) advising or assisting another fiduciary in relation to the performance of any investment functions,

This relates to section 2(1)(c) of the draft legislation, which includes investment consultants within the scope of persons to whom these provisions will apply (see section 4.1 above for further discussion of this).

(h) taking such steps as the fiduciary considers reasonable to ascertain the views of beneficiaries in relation to the fiduciary's investment activities; and

This relates to section 1(1)(e) of the draft legislation, which authorises fiduciaries to take account of their beneficiaries' views. For the reasons discussed in 4.2(e), it is increasingly difficult to maintain that beneficiaries' views have no place in fiduciaries' decision-making. The reference here to 'such steps as the fiduciary considers reasonable' ensures that the inclusion of this element does not amount to a new prescriptive requirement or an additional burden on trustees and other decision-makers. Rather, it simply ensures consistency with the rest of the draft legislation, and clarifies that ascertaining beneficiaries' views may be a legitimate part of a fiduciary's activities - for example, if they wish to offer an ethical option which reflects those views, or to take account of them in their general investment and engagement policies.

(i) collective action with other market participants to further any common interests.

This clarifies that collaborative engagement is a legitimate tool for investors to use, thereby supporting Principle 5 of the Stewardship Code, which states that *"institutional investors should be willing to act collectively with other investors where appropriate"*.[47] It also complements efforts to dispel concerns that collaborative investor initiatives may fall foul of concert party rules. In particular, it addresses an issue arising from the judgement in Cowan v Scargill, which ruled that the pension fund in question, although large, could not by itself have an impact on macroeconomic conditions. This contributed to the judge's decision that the defendants' proposed investment policy was contrary to their fiduciary duties. This presents a potential problem for investors seeking to act on issues such as climate change, which may affect their beneficiaries but which they cannot materially influence alone. However, rather than prohibiting them from acting at all, this should point towards effective collective action which can have an impact on the problem, thereby optimising outcomes for all beneficiaries.

5. Conclusion and next steps

The further work conducted since the publication of FairPensions' original report, '*Protecting our Best Interests: Rediscovering Fiduciary Obligation*', has confirmed our initial conclusion that statutory clarification of investors' duties is needed. It has also helped us to refine this proposal and to illustrate in more detail how such clarification could be achieved. However, the draft legislation appended to this report is not intended as a final word on the subject, but as a further contribution to this important debate. We welcome comments and suggestions and hope to continue the constructive dialogue which has begun over the last year. There is also clearly scope for further work about how these principles may apply to other types of investor or in other jurisdictions.

It seems likely that departmental responsibility for any changes would be held jointly between DWP, BIS and HM Treasury, particularly given the consensus that any measures taken in this area should have broad applicability. We hope that these departments will continue to engage with this agenda and to co-operate closely with each other, with relevant regulators including the FRC, FSA and TPR, and with the results of Professor Kay's Review of UK equity markets.

In parallel, we are also taking forward the recommendations contained in chapter 2 of our initial report, which considered how fiduciary duties apply to today's complex investment chains, with a particular focus on the management of conflicts of interest and on ensuring clear lines of responsibility and accountability in all types of pension savings. Following two further roundtables in April 2012, we will be publishing the results of this work, which may or may not involve suggested additions to the draft legislation outlined here. If you are interested in this work and would like to be kept informed, please contact christine.berry@fairpensions.org.uk.

Appendices

Appendix A

Draft legislation for a fiduciary investor equivalent of section 172

Section 1 Fiduciaries: performance of investment functions

1 In the performance of any investment functions a fiduciary must act in the way the fiduciary considers, in good faith, would be most likely to be for the benefit of the beneficiaries as a whole and to be fair as between the beneficiaries, including as between present and future beneficiaries. In doing so, the fiduciary may have regard (amongst other matters) to:

(a) the likely consequences of any investment activities in the long term,
(b) the impact of any investment activities on the financial system and the economy,
(c) social and environmental considerations, including
  (i) the implications of social and environmental factors for return on investments, and
  (ii) the impact of any investment activities on communities and the environment,
(d) the implications of any investment activities for beneficiaries' quality of life, and
(e) the views, including the ethical views, of beneficiaries.

2 If a fiduciary considers that the general adoption by market participants of a particular standard of conduct has been or would be conducive to the benefit of the beneficiaries, the fiduciary may observe and promote the standard notwithstanding any rule of common law or equity which might otherwise oblige the fiduciary to act contrary to the standard or to require or influence any other person to do so.

3 In this section
"***beneficiaries***" means persons for whose benefit investments are being, will be or may be applied, whatever the particular form of ownership under which investments are held for the time being.

"***benefit***" includes -
(c) financial benefit provided out of investments; and
(d) any benefit which the fiduciary considers can be conferred on beneficiaries without any material prejudice to long-term return on investments.

"***fiduciary***" means a person or institution to which this section applies.

"***investment activities***" means any actions taken in the performance of any investment functions.

"***investment functions***" includes (amongst other matters) such of the following as pertain to the particular description of fiduciary -
(a) the selection, retention and realisation of investments,
(b) the exercise of rights, including voting rights, attaching to investments,
(c) engagement with the managers of investee companies and other investee entities, including in relation to corporate governance and corporate actions,
(d) the selection, appointment and monitoring of investment managers and other agents to whom the fiduciary delegates any investment functions,
(e) the selection and ongoing review of any investment funds which are operated by institutions acting as principals and in which the fiduciary invests,
(f) the selection, appointment and monitoring of investment consultants and of other advisers in relation to the performance of any investment functions,
(g) advising or assisting another fiduciary in relation to the performance of any investment functions,

(h) taking such steps as the fiduciary considers reasonable to ascertain the views of beneficiaries in relation to the fiduciary's investment activities; and
(i) collective action with other market participants to further any common interests.

"***investments***" means the investments in relation to which any investment functions are performed and, where the context admits, includes assets of any kind representing such investments.

"***standard of conduct***" includes (without limitation) a standard which a fiduciary considers to be in accordance with
(a) widely accepted norms of behaviour relating to environmental, social or governance issues, including any such norms set out in international conventions, voluntary codes of practice or otherwise, or
(b) the views or values of beneficiaries.

Section 2 Persons or institutions to which section 1 applies

1 The persons or institutions to which section 1 applies are -
(a) the trustees of a trust scheme as defined in section 124(1) of the Pensions Act 1995;
(b) any person or institution to whom the trustees of a trust scheme have delegated any of their investment functions as defined in section 1(3), in relation to the performance of such functions;
(c) any person or institution whom the trustees of any trust scheme have appointed to advise or assist them in the performance of their investment functions, in relation to the giving of such advice or assistance;
(d) undertakings authorised under the Financial Services and Markets Act 2000 to carry on long-term insurance business, that is, the activity of effecting or carrying out contracts of long-term insurance within the meaning of the Financial Services and Markets (Regulated Activities) Order 2001 (S.I. 2001/544), in relation to the effecting or carrying out of any contact falling within paragraph VII (Pension fund management) of Part II of Schedule 1 to that order; and
(e) any person managing the investments of a personal pension scheme as defined in section 1(1) of the Pensions Schemes Act 1993, in relation to such management.

2 The Secretary of State may by regulation -
(a) provide that section 1 applies to further descriptions of person or institution either generally or in prescribed circumstances;
(b) provide that where, by virtue of subsection (1) of this section, section 1 applies to any description of person or institution in prescribed circumstances only, it shall apply in further prescribed circumstances or generally;
(c) provide that where, by virtue of regulations made under paragraph (a) or (b), section 1 applies to any description of person or institution either generally or in prescribed circumstances, it shall no longer so apply but no such provision shall restrict the scope of subsection (1).

Appendix B

List of attendees at 19 October seminar

Alice Chapple *(Forum for the Future)*

Prof. David Collison *(University of Dundee)*

Alastair Cowie *(Dept for Business, Innovation & Skills)*

John Davies *(ACCA)*

Paul Dickinson *(Carbon Disclosure Project)*

Elliot Frankal *(ESG Communications)*

Philip Goldenberg *(company law expert)*

Mark Goyder *(Tomorrow's Company)*

David Howarth *(Cambridge University)*

Howard Jacobs *(Universities Superannuation Scheme)*

Rob Lake *(United Nations Principles for Responsible Investment)*

Georgina Marshall *(Aviva Investors)*

John Mellor *(Foundation for Governance Research & Education)*

Chris Milne *(Dept for Business, Innovation & Skills)*

Claire Molinari *(Sarasin & Partners LLP)*

Paul Moxey *(ACCA)*

Charles Scanlan *(former Head of Pensions, Simmons & Simmons)*

Paul Todd *(National Employment Savings Trust)*

Raj Thamotheram *(Independent Strategic Advisor, Investment)*

Janet Williamson *(Trades Union Congress)*

All participants attended in their personal capacity; organisational affiliations are given for information only. The views expressed in this paper are our own and are not necessarily those of roundtable participants.

Appendix C

Section 172, Companies Act 2006

172 Duty to promote the success of the company

1 A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to-

(a) the likely consequences of any decision in the long term,
(b) the interests of the company's employees,
(c) the need to foster the company's business relationships with suppliers, customers and others,
(d) the impact of the company's operations on the community and the environment,
(e) the desirability of the company maintaining a reputation for high standards of business conduct, and
(f) the need to act fairly as between members of the company.

2 Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.

3 The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

Source: http://www.legislation.gov.uk/ukpga/2006/46/section/172

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