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FRESHFIELDS BRUCKHAUS DERINGER, 2005. *A legal framework for the integration of the environmental, social and governance issues into institutional investment.* UKSIF summary, 2009.

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I. Key points

- The responsibility for deciding where most of the assets are invested are the agents', not the asset-owners'.
- Jurisdictions:
  - o Common law jurisdictions (UK, US, Canada and Australia): rules are articulated in statute and in decisions of the courts; rules are more flexible and open to re-interpretation
  - o Civil law (Spain, France, Italy): rules are code or statute-based; rules are more rigid. Civil law does not recognise fiduciary duties.
- The most important fiduciary duties are the duties to act prudently and the duty of loyalty (to act in accordance with the purpose for which investment powers are granted).
- A decision maker may incorporate ESG criteria into decision-making so as to include the beneficiaries' interests.
- The link between ESG factor and financial performance are been increasingly recognised in the sense that integrating ESG considerations contribute to better predict financial performance. In addition, integrating ESG factors to include beneficiaries' views and to decide between investments of the same value are also accepted.
- Arguments for and against incorporating ESG factors into decision-making:
  - o Neo-classical arguments:
    - ▪ Against: Any deviation from profit-maximization is subversive.
    - ▪ Against: ESG issues are difficult to quantify.
    - ▪ Against: ESG performance will be of little application in a short-term environment
  - o Business-case arguments:
    - ▪ Against: Screening and shareholder activism should be exercised as long as they do not compromise profit maximization.

      - For: There is a positive relationship between ESG performance and economic performance.
      - For: Universal investors are affected by issues of concern to society due to the cross-section of the economy that they own.
  - Broader social arguments:
      - For: Integrating ESG issues is also about asking businesses to move away from prioritizing profit.
      - For: Certain investors believe that they should abide to international treaties and some public sector funds believe that externalizing costs to companies/state is not in the best interests of the fund/beneficiaries.
      - For: Investors have a moral responsibility to encourage CSR on companies.
- A research conducted after the Pensions Act 1995 was amended (2000) founded that over half of the respondents were incorporating ESG criteria into their decision-making investment process.
- One of the barriers for ESG incorporation is the misunderstanding of the law that fiduciary duties are equal to profit maximization.
- Insurance companies are required to keep a separate fund for long-term reserves and to observe limits on investment in certain asset classes.
- Fiduciary duties apply to trustees directly and to fund managers/investment consultants indirectly.
- Cowan and Scargill's decision has been interpreted as profit maximization, which is not considered a reliable legal authority.
- The UK law assesses the propriety of investment decision-making against the correct process (e.g. whether all relevant considerations were identified by the decision-making before he made a decision) and proper purpose (e.g. best interests of beneficiaries).
- Government policies:
  - Statement of Investment Principles: 2000 reform requiring trustees to disclose their policies
  - Myners Principles
  - Pensions Reform: amends the Pensions Act 1995 to impose on trustees a certain level of knowledge and understanding of the trust deeds and rules
  - UK government sustainability policies (Securing the Future): government initiative on sustainable development
  - The London Principles: encouraging financial institutions to adopt 7 principles to sustainable development
- Industry policies:
  - ABI's Disclosure Guidelines on Socially Responsible Investment
  - Combined Code on Corporate Governance
  - The Responsibilities of Institutional Shareholders and Agents (ISC)
- It is difficult to find consensus as to the interests of beneficiaries. However, it is accepted that the average beneficiary would agree not invest into investment that are linked to breaches to human rights, labour conditions, corruption or environmental protection.

- The Pension Law Review Committee published a report in 1993 stating that, when there are investments to be selected that are supposed to offer the same financial benefits, they can be chosen based on ethical criteria.
- Institutional investors, such as insurance companies and non-trust pensions, as they are not based on trust structures, are not limited by fiduciary duties for investment decision-making, but have to respect duties in negligence and contract.
- The UK courts have not specifically considered the benefits of engagement. However, Myners argues that appropriate effective engagement contributes to seeking value maximisation for their shareholders. Thus, this report believes that a court would trust shareholder engagement as prudent.

II. Key quotes

- "…investment decision-making is an art rather than a science: there is no formula that guarantees a particular outcome" (Freshfields 2005, p. 7).
- "Fiduciary duties are the key source of limits on the discretion of investment decision-makers in common law jurisdictions" (Freshfields 2005, p. 8).
- "Broadly, fiduciary duties are duties imposed upon a person who exercises some discretionary power in the interests of another person in circumstances that give rise to a relationship of trust and confidence" (Freshfields 2005, p. 8).
- "A majority of the jurisdictions have legislated (or are expected to do so shortly) to require investment decision-makers, particularly in the pensions context, to disclose the extent to which they take ESG considerations into account" (Freshfields 2005, p. 11).
- "Climate change is an obvious example of an environmental consideration that is recognised as affecting value" (Freshfields 2005, p. 11).
- "…no investment decision should be made solely in the interests of or to give effect to the personal views of the decision-maker. However, a decision-maker may integrate ESG considerations into an investment decision to give effect to the views of the beneficiaries in relation to matters beyong financial return. Courts in the UK have recognized that trusts such as charities are entitled to exclude investments that conflict with their values…" (Freshfields 2005, p. 12).
- "The duty to act in the interests of the beneficiaries means that no investment decision should be made solely in the interests of or to give effect to the personal views of the decision-maker." (Freshfields 2008, p. 12)
- "When portfolio managers are hired and paid under mandates to outperform over the following few quarters or year, they tend to ignore longer-term issues that have tremendous future costs for their fund investors, society and portfolio companies" (Freshfields Bruckhaus Deringer 2005, p. 28).
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- "…in requiring trustees to monitor the work of the fund manager to whom their discretion has been delegated, the legislation effectively places the ultimate responsibility for the appropriate management of the fund with the trustees" (Freshfields 2005, p. 84).
- "It has been argued that fund managers may in certain circumstances be subject to fiduciary duties directly, such as where they control investments on behalf of others and have a wide discretion as to how they manage the investment; but these arguments have yet to be tested before the courts" (Freshfields 2005, p. 85).
- "Investment consultants are in a different position to fund managers because they do not exercise any discretion on behalf of trustees but rather merely provide advice" (Freshfields 2005, p. 85).
- "The Charity Commission, which has responsibility for supervising UK charities under the Charities Act 1993, has issued guidance emphasizing that charities can make investments that do not seek the best financial returns, providing they further the organization's charitable purpose" (Freshfields 2005, p. 88).
- "Nevertheless, we think there is a strong argument that there will be a class of investments that could reasonably be assumed offensive to the average beneficiary such that they could lawfully be excluded from an investment portfolio without all the beneficiaries' express consent. That class of investments will not be fixed and a conservative approach is advisable, but the types of investment that might fall into that class include investments that are linked to clear breaches of recognised norms, such as international conventions on human rights, labour conditions, latcking corruption and environmental protection." (Freshfileds 2005, p. 96)

III. Definitions

- Beneficiaries: the person for whose benefit property is held in trust
- Fiduciary duties: duties that common law jurisdictions impose upon a person who undertakes to exercise some discretionary power in the interests of another person in circumstances that give rise to a relationship of trust and confidence
- Investment decisions: activities associated with the selection, retention and realization of investments and extend to the provision and receipt of investment advice. It includes decisions associated with engagement.
- Investment decision-makers: participants in the investment chain who most directly influence institutional investment management
- Passive screening: involves making investment decisions by following indices with ESG benchmarks
- Positive screening: inclusive criteria that must be met before an investment is included within a portfolio
- Negative screening: applies criteria to exclude companies on eth basis of ESG performance

IV. Best practices

- British Post Office pension fund: states that investment managers should screen companies that behave without due regard for the environment/society
- Environment Agency pension fund: fund managers should justify any investments that are environmentally controversial