UKSIF
UK Sustainable Investment and Finance Association

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Mr David Hertzell
Law Commission
1st Floor, Tower
52 Queen Anne's Gate
London SW1H 9AG

fiduciary.duties@lawcommission.gsi.gov.uk

Dear Mr Hertzell

Re: Law Commission Consultation Paper No. 215 - *Fiduciary Duties of Investment Intermediaries*

Thank you for the opportunity to comment on the Law Commission's consultation paper on *Fiduciary Duties of Investment Intermediaries.* Please find below UKSIF's response, with our comments divided between longer commentaries and answers to your questions.

Our principal conclusion is that the law relating to fiduciary duty would benefit from statutory clarification in one key area, namely that **trustees should (rather than may) consider wider factors in investment**.

We also ask you to recommend the use of appropriate mechanisms, which may include statutory means, to make it clear that:

- Trustees can consider proxies for beneficiaries' ethical views in certain cases.
- Where trustees do not engage in stewardship activities themselves, they should be encouraged to instruct their fund managers to do so.

Our response has five sections:

A. Introduction and context
B. Discussion of some aspects of Chapter 10:
   1. Definitions and investment approaches
   2. "May" versus "should"
   3. Ethics and the views and values of beneficiaries
   4. Our proposed solutions
C. Industry focus:
   1. Stewardship and engagement
   2. The investment chain
D. Answers to the questions you pose
E. Appendix

We would like to thank you and other members of your team for meeting UKSIF and some of our members on 6th January 2013. Our response draws not only on the discussions which took place then, but also from more general conversations held with Law Commission officials at some of the consultation events you have held; member feedback; and previous UKSIF policy submissions. Relevant submissions include those to: the *Kay Review on Equity Markets and Long-Term Decision Making* (November 2011); the Financial Reporting Council (FRC)'s paper on *Revisions to the Stewardship Code* (July 2012); and the Labour Party-commissioned Cox Review on the impact of short-termism on British business (August 2012).

A. Introduction and context

About UKSIF

UKSIF supports the UK finance sector as a global leader in advancing sustainable development through financial services. We promote and support responsible investment and other forms of finance that advance sustainable economic development, enhance quality of life and safeguard the environment. We also seek to ensure that individual and institutional investors can reflect their values in their investments.

UKSIF was created in 1991 to bring together the different strands of sustainable and responsible finance nationally and to act as a focus and a voice for the industry. UKSIF's 250+ members and affiliates include pension funds, institutional and retail fund managers, banks, financial advisers, research providers, consultants and non-governmental organisations. We feel this is a uniquely wide coverage of the UK financial sector. For more information about UKSIF and its members, please visit www.uksif.org.

Our aims in this response, your terms of reference and *"in practice"*

Our response will focus on possible solutions to the difficulties currently being experienced by asset owners and trustees rather than the legal detail. Mapping our response to your terms of reference we will be focusing primarily on items 2 and 4. In particular we will be asking if the laws on fiduciary duty are working *"as applied in practice"* and we will have in mind the *"ultimate beneficiaries"* which includes those who will be receiving payments many years in the future.

This approach reflects the origins of the inquiry in the Kay Review, and we see the exercise as aiming to improve the effectiveness of UK investment in practical ways. We will aim to observe the necessarily legal approach an investigation of this type demands, but we may use lay language to reflect practical industry expectations and needs.

Short-termism

As outlined in previous policy submissions, UKSIF agrees with the finding of the Kay Review that short-termism is a problem in UK securities markets and that *"we must create cultures in which business and finance can work together to create high-performing companies and earn returns for savers on a sustainable basis."* [1]

We do not plan to add anything more in the way of data or example on this point, as we take it as agreed that an overarching problem of short-termism exists.

Our response to this consultation paper is informed by several linked observations and beliefs stemming from Kay, in particular the following:

[1] The Kay Review, introduction

- Short-termism in securities markets is often undesirable in the trusts context generally; in pensions in particular it will tend to reduce returns for beneficiaries.
- Too great a focus on short-term market returns will tend to lead to sub-optimal capital allocation with adverse consequences for the wider economy.
- Uncertainty over "fiduciary duty" plays a part in promoting short-term behaviours.

The overwhelming experience of our members is that "fiduciary duty" is regularly cited as a reason for either not adopting various courses of action or persisting with unhelpful activity, such as quarterly investment reviews which are focused almost entirely on performance, rather than discussion of more material longer-term factors. We think you heard this view expressed when a group of our members met you at the roundtable on 6th January and we do not articulate it further in this paper.

Furthermore, in our discussions with you, we have considered why few trustees have been prepared to go on record as being concerned by fiduciary duty. Our view, repeated in greater detail in our answer to question 7, is that for personal reasons they are reluctant to disclose their uncertainty.

B. Discussion relating to Chapter 10

1. Definitions and investment approaches

In paragraph 10.44 the consultation paper states that many investment firms now consider environmental, social and governance ("ESG") factors and that this *"does not fundamentally alter the traditional approach; it merely extends it by taking a more holistic approach to valuing a company"* and there is merit in this assessment. But in paragraph 10.46 the paper lists three ways in particular of using ESG factors and this paragraph can be read to give the impression that the process is overwhelmingly driven by screening – be it negative, positive or best in class. However, this paragraph therefore fails to give a full picture of the richness of investment approaches that mark the UK as a leader in this type of activity. We give more background in the Appendix in Section E.

Similarly your description of ethical investment is incomplete and inaccurate. Section 4 in Chapter 10 implies that ethical investment is synonymous with exclusion (paragraphs 10.99, 10.100 and 10.103), although 10.101 does recognise other methods exist. In fact, as with ESG investing, there are a variety of ethical investment approaches as outlined in the Appendix.

We would recommend that the final report acknowledges the breadth of options available to trustees in ESG and ethical investing. The paper does recognise the academic evidence that ESG investing can be beneficial.[2] There is some overlap between ESG investing and ethical investing and some of the performance benefits ascribed to the former may accrue to the latter. In fact we have been told by several members that in terms of performance, costs and tracking error (an approximation to investment risk in a portfolio) some ethical portfolios are now comparable to mainstream portfolios.

2. "May versus should"

a) Lack of clarity in the law

We agree with the conclusion in paragraph 10.32 that "*the requirement to act in the best interests of beneficiaries is best seen as a bundle of duties*" but would go further.

Our perception is that the case law in particular sets out what trustees may not do but gives little practical guidance as to what they should do other than in the most general terms. This may be an unavoidable aspect of judge-made law, and this system may have the strength of flexibility, but since the review is in part about what is done in practice this significant defect in the way the system is working should be noted and addressed. Deducing the legal position is a difficult and imprecise process and it is unreasonable to expect trustees to undertake it.[3] They rely on professional advice and our experience is

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[2] Footnotes 65 and 66 to Chapter 10

[3] The text cited in paragraph 5.18 which says fiduciary duties "*define the point at which a court will be prepared to say that….[the trustee] has not acted in the beneficiaries interests*" sums up the negative, proof - by- exception position.

that this is often overly conservative and sometimes, in layman's terms, "wrong". We believe you have recently been made aware of a case where a set of charity trustees received legal advice running directly contrary to guidance from the Charity Commission. That such a situation can arise makes it clear that the system is not working well enough. It might also indicate that the provision of guidance in these matters is not, in itself, sufficient to promote best practice and that a statutory clarification would be a more effective solution.

b) Interpretation of the law

We believe the conclusions you have reached reflect the difficulties with judge-made law mentioned in paragraph 12.68, namely that few cases are brought, that even these are not always directly relevant and that there are time lags. We think this last concern links to an important point for analysis of how the system works today in practice: what trustees need is guidance which reflects circumstances now and as they may be anticipated to develop, not extrapolation from the past where that extrapolation is infused with the prudence of the legal profession.

This is where real life meets the law and we would invite the Commission to place more emphasis on considering current circumstances in its analysis. If the Commission feels its process or the law itself cannot offer firm and robust guidance on which a lay trustee can rely, then we think that confirms the law cannot cope with the current situation, probably because it is unable to evolve sufficiently quickly. The law needs to be clarified.

Please find below our comments on a variety of areas as evidence of how an informed and forward-looking approach would tend to more broad and robust conclusions which might support a move to the long-term approach Kay urged.

c) Consideration of the future as opposed to the past

i) Trustees and the law

In paragraph 6.23 you refer to "*circumstances that are relevant at the time they act which they knew of or ought to have known*"[4] which makes it clear there is an obligation on trustees to be aware of material factors. We interpret this as a "live" duty which means they have to be conscious of changes in circumstances and of the factors which are material. We think this is echoed in paragraph 6.67 where you make it clear that whilst trustees are not to be judged in hindsight they are governed by a standard of care which *"must be based on events as they occur, in prospect, and not in retrospect."*[5]

[4] We believe this is your summary of the cases listed in footnote 31 of the paper. Emphasis added.
[5] Paragraph 6.67, emphasis added.

The ruling cited in paragraph 6.67 shows a forward-looking consciousness is required, echoing the tone of your analysis in 6.23 above, and we think no objective assessment of lay trustee duties could exclude it.

In connection with the concept of duties changing and some element of forward-thinking being necessary, we interpret paragraph 6.52 as endorsing this idea.

> *"Those subject to a duty of care are expected to apply a level of proficiency and competence. This concept is "organic and malleable". It evolves to take account of prevailing social norms."* [6]

Although not legal specialists, it seems clear that the three paragraphs we have referenced here are suggesting that at least some duties (and if some why not all?) are only properly exercised if trustees take into account possible future developments.

In this context, the reference you make to prevailing social norms is important since we fear it is recognition of these changes in widely held attitudes and views which a conservative interpretation of the current law may delay. This is a key weakness of the retrospective approach driven by case law.

ii) <u>Trustees and the investment regulations</u>

We believe the same need to consider the future is implicit in the Occupational Pension Schemes (Investment) Regulations 2005 (henceforth "investment regulations") and one way of correcting weaknesses in the current system might be for the Commission to recommend clarification of the regulations. We also believe that the law as discussed in the consultation paper would tend to force trustees to take into account wider concerns when considering the regulations.

The regulations which are most relevant are as follows:

- Investment of the scheme assets must be in the best interests of the beneficiaries (4.2).
- Assets must cover the liabilities of the scheme and be invested in a manner *"appropriate to the nature and duration"* of the future benefits (4.4).
- Assets should be diversified "*so as to avoid accumulations of risk in the portfolio as a whole*" (4.7).

We think that, in the context of Regulation 4.2, trustees have to consider all beneficiaries fairly and, when taken in conjunction with 4.4, this must mean fair consideration of liabilities falling due well into the future. Regulation 4.7 then demands appraisal of investment risk and surely this must be considered not only in the present but in the context of future risk. Whilst immediate action may not be

[6] Extract of paragraph 6.52. the quotation marks around "organic and malleable" are the paper's.

required to avoid identified longer-term risks (we accept the tenor of paragraph 6.54 that risks can be taken), it seems clear that the existence of those risks should be noted.

d) Applying this thinking

We believe applying the thinking outlined in the two sections above would cause a revision to your conclusions in respect of two of the five categories considered in Chapter 10. To illustrate the first - the consideration of wider investment factors - we use a hypothetical case study in the highlighted box at the end of this section.

In the light of our case study we feel that trustees who did not consider wider factors would be - and if not, should be - more exposed to criticism than paragraph 10.66 would suggest. And we feel this will become more the case as time progresses and evidence of the impact and effects of climate change mounts.

Since we believe both that trustees should consider this particular risk and that considering wider factors of this kind will tend to stimulate longer-term investment of the kind Kay advocated, we think the thrust of paragraph 10.66 should be altered materially. We would suggest something along the lines of:

"We think the duty of care and the need to demonstrate appropriate consideration of the future means trustees should consider wider factors of the kind encompassed by ESG-focused issues. The body of evidence[7] *that the investment impact of ESG consideration is often positive should be explicitly taken into account. There are a variety of ways to integrate ESG considerations into investment which can be either implemented directly or incorporated into fund manager assessment, selection and monitoring."*

3. Ethics and the views and values of beneficiaries

We feel the definition of ethics used in the paper is too narrow even given the concerns raised by Lord Nicholls in paragraph 10.102. Many of our members would challenge the implication of the opening sentence of paragraph 10.98 "*Ethical investment is most commonly raised by those investing on behalf of religious groups.*" In fact, large numbers of non-faith groups do use UKSIF members to execute investment with an ethical bias: two-thirds of one specialist manager's clients are charities which ask for screening, and another specialist has some 2,000 non-faith charity groups invested in a pooled fund.

As discussed previously, the consultation paper is also very narrow in its consideration of possible ethical investment approaches.

The issue of ethics and member values and views arises in pension funds since in defined benefit (DB) schemes beneficiaries are increasingly making contributions and adding to the

[7] E.g. the references in footnotes 65,66 and 69 to Chapter 10

pool of assets, the benefits of which they will enjoy. These contributions are a form of saving and it is hard to argue that those savings should not reflect to a degree at least the values of the contributors. We think the law as it stands is simply inappropriate given the newly evolved class of pension beneficiary-contributors.

We think the solution in this very difficult area is again linked to the concept of the "organic and malleable" duty of care outlined in paragraph 6.52. We think that, where trustees can point to an evolving social norm which they can reasonably believe would be shared by their beneficiaries, they should be able to reflect that in their work.

Clearly there is a risk of abuse and a mechanism should be found to prevent that. We suggest that the method might be to look at elements such as:

- The tone and content of intergovernmental legislation and initiatives
- The content and longevity of national legislation
- To a degree, the behaviour of large numbers of people evidenced by their consistent membership of organisations

(We note your comment in paragraph 14.25 that trustees should not invest in areas which contravene international convention. We think our suggestion is a development of that approach.)

In general the elements listed above will only materialise if a consensus exists which can survive public engagement through elections or successive campaigns. We think such a consensus could be interpreted as evidence of a prevailing "social norm". We suggest that the investment process would benefit if it were made clear that trustees could reflect what they could reasonably claim was a proxy for beneficiary views if they were evidenced by elements like those listed above.

We accept that reflecting beneficiaries' ethical interests is complex, and we recognise that in many cases the process alluded to in the paper whereby regulatory and reputational risk give rise to financial grounds for divestment may give the same outcome. But for evolving issues, clarification on how trustees can consider the changes in society's attitudes would be helpful. It may be that further work in this particularly complex area is necessary.

4. Our proposed solutions to the issues in this section

Our suggested solutions reflect our focus on items 2 and 4 in the Terms of Reference which we summarise as the approach to investment strategies and whether fiduciary duties are working in the best interests of beneficiaries.

a) <u>Provision of guidance on what trustees should consider</u>

Under the heading "May" versus "should" (and in our answers to questions 1, 2, 11, 12, 13 and 15 below), we argue that trustees should be looking more widely and more long-

term when considering investment matters. We feel the whole issue shows that the law surrounding "fiduciary duty" does require addressing and clarification.

The question is how best to help trustees understand the nature of their duties in the modern day, and how to help them change their behaviour most rapidly. In question 18 we have listed some possible solutions that can be summarised as below:

- Statutory intervention
- Greater detail in the investment regulations
- A statement by the Law Commission, or the relevant regulators or government departments, as to what trustees should consider in terms of investment in the light of developments in scientific consensus and societal attitudes since the cases cited in the consultation paper

Our view is that changing trustee behaviour is essential to building the system and economy envisaged by Kay. **We believe that all the routes listed would help but that statutory clarification would be the most the effective option, followed by use of the investment regulations.** We would urge you to particularly consider both of these and not to rule out the statutory route unless you have confidence in the ability of the other approaches to deliver.

b) Allowing trustees greater discretion in assessing members' views

We feel your definition of ethics is too narrow, but recognise that ethics are very difficult to define. But it seems wrong that, as members contribute increasing sums to DB schemes, their views and values are not considered. In our section on this topic, we have suggested that it would be possible to discern society's views on issues where legislation or inter-governmental agreement implicitly or explicitly highlighted attitudes, and we suggest that trustees might then be allowed to assume that their beneficiaries shared those views and would want them reflected in the fund. If necessary, statutory measures should be used.

Case study: Wider investment factors, including environmental, social and governance (ESG) factors

You conclude in paragraph 10.55 that trustees *may* consider ESG factors citing evidence that such factors "can" lead to better returns, but you also stated in paragraph 10.64 that the law did not *demand* such consideration and confirmed this in paragraph 10.66. We are not qualified to contradict your view of the current law if the retrospective approach driven by historic case law is applied, but we feel that if a case was brought now the outcome may well be different.

Let us hypothesise:

One such case might revolve around how trustees consider the future, a duty we think is made clear in the Commission's paragraphs referenced above and in our comments on the investment regulations. The substance of the particular case would concern climate change and whether the trustees had been remiss in not considering it.

Complaining beneficiaries would say the data they cite on the future is of high quality and that the consequences seen already are material and such as to affect the future shape of the economy and of investment. Is this true?

We list here some elements linked to climate change which suggest these factors will affect the future and should be considered. We should note that they are widely considered not to be *"external pressure to do the next fashionable thing"* (paragraph 10.93):

Data source

The Intergovernmental Panel on Climate Change was established by the United Nations Environment Programme and the World Meteorological Organisation in 1988 and endorsed by the General Assembly of the United Nations in that year. Its five successive reports have detailed the growing scientific consensus that man-made climate change is occurring.

Consequences

In the UK context, the following high-level consequences can be noted:

- The Climate Change Act 2008, mandating an 80% cut in greenhouse gas emissions by 2050, passed with only 5 MPs voting against. Not repealed by incoming government.
- National risk register: Climate change is accepted as a fact with the 2013 assessment saying in part "*As the climate continues to change, the frequency of more extreme weather events is likely to increase."* [8] One of the threats is coastal flooding.
- Nuclear power: Britain will build nuclear power stations for the first time in a generation.
- The carbon bubble: Research by Carbon Tracker[9] suggests that two-thirds of hydrocarbon assets owned by listed companies cannot be burned if we are to keep global warming to 2°C.

[8] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/211867/NationalRiskRegister2013_amended.pdf p24

[9] http://www.carbontracker.org/carbonbubble

Investment implications

If we focus on the implications to a theoretical electricity generator, the serious consequences of the example are seen.

- The industry will have to play a leading part in cutting greenhouse gas emissions meaning the threat of obsolescence to existing plant is increased.
- To preserve market share investment in nuclear power stations may be demanded.
- Nuclear power stations built near the coast will have to be proof against the higher threat of coastal flooding meaning higher cost.
- If the theoretical company owned any hydrocarbon assets they would risk losing value as it became apparent that they were less likely to be burnt as carbon use is reduced.

Clearly investment in such a company in the long-term would demand careful analysis since there are risks. On the other hand the opportunities in other energy-related areas may be attractive: venture capital owned alternative energy suppliers may do well; French electricity companies that can build and run nuclear power stations may do well; suppliers of the cleanest hydrocarbons - perhaps American shale gas producers - may do better than established "dirty" hydrocarbon producers.

Implications for trustees

The trustee body has several linked roles in this hypothetical case study:

1. In the current system of contracts and outsourcing, the trustee should be expected to consider the long-term implications of factors such as the Climate Change Act 2008 - which will play out until at least 2050, as well as other international climate change treaties and targets.

2. No stakeholder other than the trustee can consider the implications across the range of asset classes held by a pension fund: someone has to consider the possibility that actions in portfolios run by different managers are in aggregate generating an accumulation of risk of the kind warned about in investment regulation 4.7. We believe it is essential that a stakeholder has this responsibility rather than it being "lost", and we believe it can only sit with the trustees. Our view of the law is that the trustees are required to be forward-looking and so the duty of implementing and maintaining a process for the management of long-term issues rests with them.

3. Whilst the decision to divest of an individual electricity company should probably sit with a fund manager, the trustee should be giving guidance as to what they require over time in terms of changing high-level exposure to themes such as climate change. This guidance must cover the gap between high-level actuarially driven funding strategy (clearly the preserve of the trustee body acting on advice) and tactics, probably rightly the preserve of the fund manager.

4. In our example the new and possibly successful investments are not in the same asset class as the at-risk electricity company. So typically a fund manager would not be able to sell the one and invest in the others on his own initiative. The investment would require a party to sanction moves into respectively venture capital and European and American equities. One would expect that to be the trustees, certainly if these were new asset classes.

Conclusions

In our view a law case brought today saying that a body of trustees were at fault for not considering the implications of climate change might well have some success:

First, the level of national and international activity linked to it is now surely so great that a trustee "ought" to consider it (see paragraph 6.23); second, even if that point has not been reached - which seems most unlikely given UK law has changed - then clearly the issue is in prospect and should be considered (see paragraph 6.67). And thirdly, since we think climate change is now a matter of societal debate - if indeed a consensus that it is happening does not exist, then we feel a trustee body which sought to ignore it entirely might be failing in not seeing that their duty of care had proved malleable as considered in paragraph 6.52.

Since we are not lawyers and are hypothesising, our theoretical case would also allow consideration of related governance material, namely the investment regulations. Whilst their current wording may well need tightening we suggest that a trustee body which in 2014 could not evidence consideration of the possible implications of climate change for long-term liabilities and for risk concentration, or for portfolio diversification overall, might also find the case harder to defend than simple consideration of past cases would suggest.

C. Industry focus

1 Stewardship and engagement

Some of our members have questioned the process descriptions in the consultation paper in respect of “stewardship” and “engagement”. As the definitions of the terms themselves are not universally agreed, we will seek to avoid them at this point, using the term “company contact” instead.

A key element which is not discussed in the Commission’s paper is the extent to which company contact can be carried out by trustees or fund managers. Large numbers of fund managers engage in company contact even if not directly mandated by their clients. In fact such activity is widespread in the pensions area where, as you say, only a few of the very largest funds engage directly. Pension funds in general are reluctant to engage directly because the work is frequently complex[10] in its subject matter and is time-consuming. This is partly acknowledged in the last sentence of paragraph 10.38.

Both UKSIF and our members think paragraph 10.38 is unfortunately worded. It may be true as stated by Tilba and McNulty in 10.38 that only 2 out of 35 pension funds exhibit “engaged ownership behaviour” (which we interpret as meaning trustee-directed). However, the fact that fund managers often engage in company contact themselves on behalf of the clients whose assets they manage means we would expect that many of the UK equity assets of the 35 large funds in 10.38 are being represented in some form of company contact.

A typical relationship would be that a pension fund appoints a fund management firm for a portion of their equity assets. That firm will engage in a greater or lesser degree of company contact which may be referred to as “stewardship”, “engagement” or “responsible engagement”.

The precise process will vary between managers but, as a minimum, would typically involve the individual fund managers being made aware of significant governance concerns affecting, for instance, pay and corporate behaviour. The source of this advice may be a specialist firm or internal staff. They would then consider this along with their knowledge from other sources of significant corporate commercial plans such as capital investment and merger and acquisition activity. This background information will inform their actions as they vote the stakes they manage for their clients on the vast majority of corporate motions put to general meetings. This base level of activity is carried out by many fund managers, and the vast majority of those in UKSIF, on behalf of all their clients including pension fund trustees.

Responsible investors as a whole were among the first to recognise the benefits of good stewardship practices and many UKSIF fund manager members offer more developed services, which consider other issues in addition to governance matters and which they

[10] Subjects might include pay, approach to industry regulation or human rights in emerging economies. All are specialist areas.

believe can provide benefit to the asset owners. These may take, for instance, the form of considering a company's position on environmental, social or ethical issues, with the subject matter identified by internal or external experts. Frequently the company contact takes place in meetings followed up by extensive written discussion. When a group of UKSIF members met you, we discussed how these forms of contact took place and the growing extent to which they saw co-operation between managers. The changes in number and form are both very positive trends which should be recognised and supported.[11]

Our members also explained why they usually prefer to keep the details of this company contact confidential. The most important reason is that the contact is better if it is long-term, and a long-term relationship of trust is not easily built in the glare of publicity. This position may be expected to evolve, and the IMA, ABI and NAPF are co-operating on an Investor Forum of the type suggested by the Kay Review.

UKSIF members engage in these activities for several linked reasons. Most would see a better understanding of a company as a good thing, likely to help their businesses by boosting investment return; some take this further and use contact as a way of driving thematic based investment. Almost all firms and the vast majority of individuals would recognise a professional duty to "know" the assets being bought by a firm on behalf of clients. The level of integrity in fund management is high.

Company contact allows a fund manager to build a more complete and rounded view of a company which helps their understanding of its strategy, its leadership, its strengths and its weaknesses. This can be termed "stewardship" and it is being exercised to the benefit of the manager's clients including the pension funds. The processes by which the contact happens can be termed "engagement".

Paragraph 10.38 mentions the importance of size of an asset owner and case study 1 at 3.82 shows how small some pension funds are. But this is to miss the point. Fund managers are typically carrying out engagement and stewardship on behalf of their clients on a combined basis. The large insurer mentioned in paragraph 3.80 does not itself own 4% of the UK equity market; it *manages* in total 4% of the market, much of it in passive funds owned by hundreds of pensions funds, some extremely small. The shares of all those clients are combined to exercise stewardship.

That small schemes can use fund managers to exercise stewardship through engagement is an important point which is not made clear in the paper. Nor is the fact that investing in a passive fund does not mean your assets are not being used for stewardship purposes. These are serious omissions; the fund management market is already working along the lines prescribed by Kay, more needs to be done but good progress is being made.

We believe that there is a generally higher level of company contact than the paper suggests and that this should be noted. However, the position is not uniform and there are many

[11] The developments could go further; our members told us that overseas asset owners with stakes in UK companies were often reluctant to engage because of concerns over the concert party provisions of the takeover code.

areas where improvement is necessary. Clarification on fiduciary duty could play a part in this by making it clear that this is an area where trustees should be monitoring the activity carried out in respect of their assets.   Statutory intervention may help or, perhaps in this area, work by the relevant regulators or industry bodies may suffice

2 The investment chain

Professor Kay thought the investment chain was becoming too long and the consultation paper perhaps implies agreement in paragraph 3.94. In 3.95 the paper goes further and says it is the intermediaries and not the law which cause trustees to avoid some innovations.

We feel these views are open to challenge. Pension funds in general keep costs under tight control. In our experience and that of our members it is unusual for a pension fund to engage a new adviser unless there is very good reason. Proxy agents are a case in point; we have said that company contact is complex and as such it is prudent for trustees and fund managers to seek expert support. That proxy agents are appearing is excellent news: it shows that professionalism is appearing and standards are rising. We note the review by ESMA mentioned in paragraph 3.64 which found no market failings in the area.

In general, we think trustees should take advice from the best available source and should, after considering their duties and the costs, be prepared to pay for it. We suspect the conclusion in paragraph 3.95 is wrong. It may be that uncertainty over the exact nature of trustee duties means trustees outsource to professionals for safety's sake, and those professionals without the pressure to do the job with a sufficiently forward-looking bent tend to be too conservative. In that case it isn't the trustees or the professionals who are at fault: it is the weaknesses of the law.

D. Answers to the questions you pose

1. *Do consultees agree that this is a correct statement of the current law?*

   The law is imprecise and assessing the current status is a matter for interpretation and extrapolation. Your conclusions differ from ours in at least one significant respect - see the discussion of "may" versus "should" in Section B.2 above.

   An important additional factor in our view is the need for the law to be able to adapt easily and in a timely manner to changing circumstances. We recognise that the law has evolved over a long period, but we are concerned that it may struggle to do so if the pace of change accelerates. Currently, it seems to us, practice develops and is eventually either tested in court or becomes standard practice. This might be acceptable if there were regular cases to aid the process, but the comment has been made that there haven't been enough. This has probably played a part in allowing the current position, where there is uncertainty over the law, to develop and there can be no guarantee that it will not continue.

   We therefore feel your report should consider how the law can be "future-proofed".

2. *Do consultees agree that the law reflects an appropriate understanding of beneficiaries' best interests?*

   Our answer is similar to that for question 1. We disagree with your interpretation of the law in certain respects and are concerned that the law cannot move fast enough to reflect the changing nature of beneficiaries' best interests. In particular, the method by which it can adapt to uncertainties that may appear as the result of a significant change in facts or public opinion - as issues cease to be the preserve of a "narrow interest group" and become recognised as "mainstream", is weak. It must surely be the case that, if a law suit is needed to establish best interests as a result of change, the system isn't working well enough.

3. *Do consultees think that the law is sufficiently certain?*

   No, as our answers to questions 1 and 2 show we have major concerns.

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

   Yes. As a matter of principle the best protection should be afforded to all schemes irrespective of size. Whilst there may be cost implications, the long-term costs of poor governance of schemes in terms of sub-optimal running generally - and sub-optimal financial management in particular - may well be higher if poorer pensions, cancelled memberships and perhaps even resolution through the Pension Protection Fund are considered.

5. *Are there any specific areas which would benefit from statutory clarification?*

   We feel that statutory intervention would be *by far* the best solution to many of the issues discussed in our response and in particular that:

   - Trustees should consider wider factors such as ESG.

- Trustees should consider longer term factors and how they evolve.
- Ideally, trustees may consider suitable proxies for widely held ethical views of beneficiaries.

There may be alternatives to statutory intervention but these would be second best.

6. *Do consultees agree that the law permits a sufficient diversity of strategies?*

We think that the Commission's interpretation of the law does permit a sufficient diversity of strategies. It is the absence of wide-ranging forward-looking discussion that leads to "herding" driven by short-term considerations and clarification of fiduciary duty will promote that.

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

The system is not working optimally for a wide variety of reasons. Not all of these are linked to fiduciary duty, but some are and we believe that this constitutes a significant impediment to the kind of long-term decision-making that both Professor Kay and UKSIF would like to see in UK securities markets

We previously noted that you have not received evidence from any group willing to go on the record as being uncertain as to their position in respect of "fiduciary duty. This is perhaps inevitable in the modern world; it is likely that any trustee who said he or she didn't understand the concept and its implications would be exposed to criticism as a minimum.

UKSIF is a membership association with, uniquely, members from every part of the UK financial services value chain. In feedback to us from all parts of that value chain, there is overwhelming evidence that concerns over "fiduciary duty" are a constraint on action:

- Advisers in some areas feel constrained in the advice they can offer.
- Producers see no scope for developing certain kinds of products.
- Asset owners themselves are nervous of using approaches which may be best in the long run but which will show returns deviating from the average in the short term.

In some cases, as has been suggested at some of the Commission's meetings, this may be an easy excuse which is used to avoid difficult decisions but we do not believe that is always the case. "Fiduciary duty" may be an easy excuse but as long as there is uncertainty over the issue it will remain an unnecessary complication.

Your final report may be an opportunity to exercise influence over one area linked to short-termism. The phrase "what gets measured gets done" has mutated in pensions to "what can be measured should be" and modern technology allows the monitoring of investment in very fine detail.

Since our fund manager members offer investment processes, very short-term performance review is rarely appropriate. It would be entirely consistent with your interpretation of the law and trustee responsibility to make it clear in your report that trustees need not review performance quarterly and could profitably consider qualitative review - rather than purely

quantitative - in less frequent meetings with fund managers. This would also be consistent with recent moves by the UK government to get rid of the practice of quarterly reporting by companies. Trustees working more closely with fund managers would build better relationships of the kind we think Professor Kay was calling for in his report.

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

   We understand that this is an extremely difficult area. Where individuals are contributing to the asset pools it seems right that they should have some influence over the values exercised in those portfolios. Our suggestion, which is not a full answer to how individuals can see their own views reflected, is that trustees be permitted to reflect societal views in their investment instructions using national and international law and inter-Governmental agreements as indications of widely held opinion.

9. *Does the law encourage excessive diversification?*
10. *Does the law encourage trustees to achieve the right balance of risk and return?*

    Our response to questions 9 and 10 combined:

    We do not believe the law encourages excessive diversification.

11. *Are there any systemic areas of trustees' investment strategies which pose undue risks?*

    Yes. It is issues at the broader systemic level which worry us most. There are many examples:

    - The scientific consensus on climate change is that the world faces a problem.
    - There is a considerable body of evidence that the use of non-renewable resources cannot continue at the current rate.
    - Some developed economies appear trapped with unsustainable fiscal models and adverse demographic trends.

    On a timeframe still generally considered as relevant to DB schemes (15-25 years), it seems likely that these issues will come to bite raising fundamental challenges to asset values. They are even more relevant to DC schemes which have a longer anticipated life.

    We have the gravest doubts as to whether the law on beneficiaries' best interests as generally interpreted now or as interpreted in your consultation paper is able to protect beneficiaries by forcing timely enough consideration of these and other similar issues. We believe that statutory clarification would help.

    An intervention the Law Commission could make in its report would be to suggest that issues of these types - both financial and more broadly based - should appear on trustee risk registers.

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

Our response to questions 12 and 13 combined:

We think the legal obligations on trustees are *potentially* conducive to investment strategies in the best interests of the ultimate beneficiaries. However, it is clear that currently they are not having the desired effect and investment generally remains too short-term. The current situation means that, for instance, factors such as climate change tend not to be explicitly considered by trustees, despite climate change not being new, not being the province of a "narrow interest group", and having enormous implications.

As our example case study under "may" versus "should" demonstrates, we feel the law does place the burden of considering factors such as climate change on trustees but in practice the law is not taking effect. It is in this failing that the problem of fiduciary duty lies since it permits and encourages short-term investment which is probably not in the best interests of beneficiaries or, as Kay argues, the wider economy.

Trustees must be encouraged to look further and more widely. The methods of achieving this are considered in our response to Question 18.

14. *Do consultees agree that the duties on contract-based pension providers to act in the interests of scheme members should be clarified and strengthened?*

    Yes. We would cite the rapid growth in assets in DC schemes, and the worrying lack of governance and protection for their savers, as evidence that the pension environment can and will change far faster than the legal and regulatory regimes. In DB and DC what is needed is an intervention which highlights that what is appropriate under law has evolved in recent years and will need constant review by governance bodies.

15. *Should specific duties be placed on pension providers to review the suitability of investment strategies over time? If so, how often should these reviews take place?*

    Yes. Providers should review the suitability of investment strategies regularly, but that need not mean frequently. The focus should be twofold: on looking forward far enough to identify issues which will grow in importance, and in being radical enough in assessing their implications. History shows numerous examples of dramatic change driven by "ordinary" forces such as innovation and population growth. How much greater will be the changes driven by extraordinary forces such as rapid climate change?

    Many of the UK financial services firms which adopt an ESG investment approach are well-positioned to apply that thinking to product development and evolution in the defined contribution (DC) area.

16. *Should members of Independent Governance Committees be subject to explicit legal duties to act in the interests of scheme members?*

    Yes. The need to protect DC assets is urgent. Assets need to be protected now for the benefit of the saver whilst the concept of saving itself needs protection.

It is not clear how pensions are to be funded for future generations; if the idea of auto-enrolment were to be compromised by a scandal we suspect the consequences could be more material and of longer duration than those of the recent banking crisis. There is a need for rapid action and since the law will have to play a part we feel there is an obligation on the Commission to highlight the requirement for speed in its report.

17. *Should pension providers be obliged to indemnify members of Independent Governance Committees for liabilities incurred in the course of their duties?*

    We are unable to comment on this question.

18. *Do consultees agree that the general law of fiduciary duties should not be reformed by statute?*

    No. We believe the current position is unsatisfactory in that funds are not putting in place systems of thinking and investment which fully reflect known and quantifiable threats to beneficiary pensions. We also believe that, were it to be considered objectively today in the light of known facts, past case law would tend to move funds to put those systems of thinking and investment in to place.

    What is needed is some way of causing funds to undertake the required review with a sufficiently open mind.

We can see several ways this could be achieved. They are listed in order of decreasing effectiveness:

- Statutory intervention
- Greater detail in the investment regulations
- A statement by the Law Commission, or the relevant regulators or government departments, as to what trustees should consider in terms of investment in the light of developments in scientific consensus and societal attitudes since the cases cited in the consultation paper

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

    We are unable to comment in detail on this issue.

20. *Is there a need to review the regulation of investment consultants?*

    We believe that there is a lack of clarity in the legal and regulatory position of investment consultants and that it should be reviewed.

21. *Is there a need to review the law of intermediated shareholdings?*

    We are unable to comment on this issue.

22. *Should the FCA review the regulation of stock lending by custodians?*

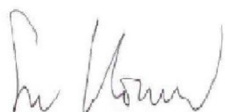
Yes. We have had concerns over stock-lending for some time. As we prepared our response to the Kay Review, we held a member seminar where:

"…particular concern was expressed about the practice of stock lending as a potential contributor to short-termism and volatility. Stock lending may benefit the institutions borrowing and lending the stock while externalising associated costs on to the wider market. In addition, asset owners may be exposed to unrecognised or unquantified counterparty risk as a result of the practice. In the light of this, we believe that the Kay Review should consider this issue."

UKSIF's 2011 *Responsible Business: Sustainable Pension* report also demonstrated that stock-lending has long been recognised as a concern by leading pension funds. We therefore believe that the Law Commission should consider issue.

I trust that our comments above are self-explanatory. If you would like any further information or have any queries, please do not hesitate to get in touch.

Yours sincerely



Simon Howard
Chief Executive
UK Sustainable Investment and Finance Association (UKSIF)

E. Appendix

ESG and ethical investment approaches

The UK is a leader in sustainable and ethical investment and firms use a wide range of methods and approaches. Given the growing number of asset classes where these approaches are applied and their continued evolution, precise definition is difficult. The six styles listed below are adapted from a pan-European survey carried out by Eurosif with input from UKSIF. They give an indication, but no more, of the variety of approaches available. [12] Most can be flexed to reflect an investor's preferences or ethics.

Sustainability-themed investment

Definition: Investment in themes or assets linked to the development and application of sustainability. Thematic funds may focus on one or more sustainability issues related to environment, society or corporate governance.

Comment: This approach may minimise risks from ESG threats and allow exploitation of opportunities.

Best-in-class investment selection

Definition: Investment in leading or best-performing companies or assets within a universe, category or class based on ESG criteria.

Comment: The hypothesis is that best in class companies will tend to be less exposed to risk and more alert to opportunities. The Deutsche bank report noted in footnote 69 in Chapter 10 may support this analysis.

Norms-based screening

Definition: Investment in companies or assets compliant with international standards and ESG norms.

Comment: Investments are screened based on international norms or combinations of norms covering ESG factors. International ESG norms are defined by bodies such as the United Nations. Again, the hypothesis is that companies which are compliant are less exposed to risk and more exposed to opportunity.

Exclusion of holdings

Definition: A style that excludes holdings in companies, sectors or countries which breach criteria set by the asset owner of fund manager. Traditional exclusions have been linked to pornography, alcohol and gambling.

Comment: This style allows investors to reflect to a greater or lesser degree their views. In general the larger the sum to be invested the greater precision which the owner can ask of the fund manager. The style can be used for active or passive investment; index providers have constructed many suitable indices to support the latter approach. Exclusion using a passive investment vehicle is an ESG style within the reach of even small pension funds.

[12] http://www.eurosif.org/research/eurosif-sri-study/sri-study-2012

Integration of ESG Factors in Financial Analysis

Definition: Investments are appraised using traditional financial analysis which explicitly includes consideration of ESG risks and opportunities.

Comment: The integration of ESG factors into mainstream investment analysis allows the potential impact of ESG issues on company finances (positive or negative) to better inform investment decisions.

Engagement and Voting on Sustainability Matters

Definition: Voting on shares and engaging with companies on ESG matters.

Comment: Also known as active ownership or good stewardship this strategy includes, but is not limited to, issues of corporate governance. Proponents can cite cases where corporate behaviour has changed to reflect investor concerns to the benefit of investor returns. This area has seen rapid growth in most developed financial markets.