The Enlightened Shareholder

Clarifying Investors' Fiduciary Duties

With the advent of automatic enrolment, up to eight million UK workers will become newly dependent on the capital markets for their wellbeing in retirement.[1] The behaviour of those who manage their money will have a decisive impact on our ability to meet the challenges of an ageing society and to provide for the next generation of pensioners.

Institutional investors are also powerful economic actors. The large pools of capital held in our pension funds have enormous potential to:

- boost the economic recovery, by supporting job-creating SMEs and green infrastructure; and
- build a more responsible capitalism, through more effective oversight of the companies they own on issues such as executive pay.

It is therefore vital that the law supports and encourages investors to play their role in sustainable wealth creation - yet at the moment, it risks doing the reverse.

PROBLEMS WITH THE CURRENT LAW

Those who manage money on behalf of others, such as pension fund trustees, have strict legal duties – known as 'fiduciary duties' – which exist to ensure they act in savers' interests. Current interpretations of this vital legal principle are dangerously dysfunctional:

The duty to ensure savers get a good return on their investment is widely seen as a narrow '**duty to maximise return'** in isolation from the real economic value of investments. This leads to a neglect of activities that may add value but do not translate immediately into short-term profits – such as exercising ownership rights and managing environmental risks.[2]

Case study: Strathclyde Pension Fund recently launched a £100m New Opportunities Fund to invest in job-creating SMEs in Glasgow, where most of its beneficiaries live and work.[3] This innovative approach remains highly unusual – perhaps partly because fiduciaries fear that they would be in breach of their duties if such a strategy delivered even a marginally lower expected return than more conventional investments.

The duty to invest prudently has become a **'lemming standard'**, assumed to require adherence to the behaviour of other investors.[4] Many trustees fear that departure from these norms – however well-justified – could leave them exposed to legal liability. This risks exacerbating herding behaviour, fuelling market volatility which ultimately hurts savers and the economy.

Case study: the dotcom bubble
In 2000 the 'dotcom bubble' burst, causing many funds to lose large amounts of value. Some fund managers had seen the bubble for what it was and avoided investing in tech stocks. In hindsight, this was clearly a prudent investment decision. Yet these managers were likely to be sacked by pension fund clients for underperforming their peers in the short-term. This is an inevitable result of interpretations of investors' duties which focus solely on the pursuit of returns and on the behaviour of other investors.

FairPensions™

POLICY BRIEFING

ENLIGHTENED SHAREHOLDER VALUE

The Companies Act 2006 aimed to "embed in statute the concept of enlightened shareholder value" by giving directors a duty to have regard to the long-term, to the impact of their decisions on communities and the environment, and to the interests of their employees.[5] Yet, five years on, this appears to have had limited impact, with significant evidence that company directors still feel compelled to focus on short-term profit maximisation.[6]

Company directors' basic duty is to promote the success of the company in the interests of shareholders. If even long-term shareholders, such as pension funds, think they are legally obliged to focus on short-term movements in share price, it is hardly surprising that this imperative is being transmitted to directors. Arguably, the Companies Act was missing a vital piece of the puzzle: it tried to embed enlightened shareholder value without creating the legal space for enlightened shareholders.

Case study: hostile takeovers
One officer of a multi-employer pension fund recounts seeking legal advice on whether, when voting on a hostile takeover, they could take account of the fact that some of their beneficiaries might lose their jobs. The response was that this was not a relevant consideration: the trustees' fiduciary duty bound them only to consider the price they would be paid for their shares.

RECOMMENDATION

The problem of persistent misinterpretations of the law, reinforced by cautious legal advice, is unlikely to be resolved without explicit clarification of the law. On 13 March 2012, a coalition of investors, experts and civil society organisations released a statement arguing that such clarification is essential "if politicians are serious about building a more far-sighted and responsible capitalism". Signatories included Aviva Investors, Jupiter Asset Management and Hermes.[7]

FairPensions has produced draft legislation illustrating how such clarification could be achieved, bringing institutional investors' duties into line with directors' duties and enabling them to better serve savers' long-term interests. This legislation is published in a new report, 'The Enlightened Shareholder: Clarifying Investors Fiduciary Duties', available at http://www.fairpensions.org.uk/fiduciaryduty.

For more information, or to request a copy of the full report, please contact:
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2. FairPensions, 2012, 'The Enlightened Shareholder: Clarifying investors' fiduciary duties', p6-7
3. See http://www.glasgow.gov.uk/en/News/New+Opportunities+Fund.htm
4. Johnson K, 2010, 'Back to the future of pension trust fiduciary duties', available at http://www.fairpensions.org.uk/sites/default/files/uploaded_files/KeithJohnsonFiduciaryDuty.pdf
5. Company Law Reform White Paper 2005, p5, available at http://www.berr.gov.uk/files/file13958.pdf
6. Collison, D et al, 2011, 'Shareholder Primacy in UK Corporate Law: An exploration of the rationale and evidence, ACCA; The Kay Review of UK Equity Markets and Long-term Decision Making, Interim Report, Feb 2012, p8.
7. The Times, 13 March 2012, 'Savers & investors', http://www.thetimes.co.uk/tto/opinion/letters/article3348990.ece