Kay Review of UK Equity Markets: Supplementary evidence from FairPensions

April 2012
Introduction

This supplementary evidence relates to academic work and anecdotal evidence which has come to our attention since our original submission, or which is pertinent to questions raised by the Review’s interim report. We have not repeated or summarised the contents of our March 2012 report, ‘The Enlightened Shareholder: Clarifying investors’ fiduciary duties’. However, we have provided some additional information, including further evidence to support the report’s conclusion that statutory clarification of fiduciary obligation is necessary, as well as clarification of some aspects of our proposals. This submission should therefore be read in conjunction with the report.

1. Supplementary evidence on investors’ fiduciary duties

1.1 Clarification and change: the case for new legal provisions

It is perhaps worth clarifying the exact relationship of FairPensions’ proposals for statutory clarification to the existing law. One obvious response to these proposals has been to ask, if the current law is adequate and is simply misunderstood, why new legal provisions are necessary. As we have said before, we do not regard our proposals in general as constituting any major departure from existing common law principles. However, it does not follow from this that they would have no substantive effect whatsoever on the legal position, or that the current position is adequate in all respects.

The majority of our proposed provisions fall into one of two main categories:

- Areas where the law is silent (e.g. long-termism, exercise of shareholder rights, consideration of environmental, social and governance (ESG) issues).
- Areas where the law is ambiguous (e.g. consideration of macroeconomic impacts or beneficiaries’ ethical views).

In both cases we believe our proposals are entirely consistent with existing case law. For instance, the permissibility of considering financially material ESG issues can be derived from existing legal principles, as the Freshfields Report sets out; the provisions relating to ethical issues extrapolate from existing law and guidance on the ‘ethical tie-break’ principle (whereby trustees are legally permitted to choose between two equally attractive investments or investment strategies on ethical grounds). In other words, we believe the proposals reflect the principles on which a judge would be likely to base his or her decision were these issues to come before the courts today.

However, in fact most of these issues have not been considered by the UK courts: paucity of relevant case law was one of the key problems cited by participants in our original 2010 seminar series on fiduciary duty. In addition there is no guarantee that any future cases would add clarity or certainty to the legal position. In the nature of things, any litigation in this field is likely to concern a policy that is at – or beyond - the margins of what is generally thought to be permissible. A resulting negative decision on a specific issue or on a particular set of facts could well throw up more general doubts about RI or stewardship than were actually justified by the judgment. For an example of this, one need look no further than Cowan v Scargill. In this context, the certainty provided by statutory clarification would constitute a meaningful change from the current situation.

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1 UNEP-FI, 2005, ‘A legal framework for the integration of environmental, social and governance issues into institutional investment’.
The key exception to these two categories relates to what Professor Kay characterised, at the launch of our report in March 2012, as being obliged to ‘pick someone else’s pocket’ if it would generate a higher return for beneficiaries. Cowan v Scargill confirmed that “trustees may even have to act dishonourably (though not illegally) if the interests of their beneficiaries require it.” This followed an earlier decision that trustees were obliged to ‘gazump’ where that was in their beneficiaries’ interests. As discussed on p16 of our report, here our proposals do substantively depart from existing case law. They would authorise trustees to adopt particular standards of conduct if they believe that the market as a whole should adopt those standards in the interests of their beneficiaries – thereby overcoming a ‘lowest common denominator’ approach to fiduciary duty and ensuring that institutional investors can behave as enlightened market participants.

As a practical example, this change in the law could help to overcome the ‘free-rider’ problem in relation to stewardship. Of course we recognise that other factors contribute to this problem, but anecdotally (see section 1.2 below) it appears that legal advice can exacerbate it by suggesting that trustees must take a narrow view of the benefits accruing to their individual fund when evaluating engagement activities. The ‘duty to gazump’, therefore, is one respect in which the existing law is not fit for today’s capital markets and must be amended. Exactly how this can be done, and whether our suggested provision is the most practicable way forward, is a matter for further discussion.

### 1.2 The role of legal advice

It is worth stressing that misinterpretations of fiduciary duty arise not just at the level of trustees themselves but as a direct consequence of the legal advice they receive. Notwithstanding the legal advice obtained by the Review, narrow interpretations of the law appear to be the rule rather than the exception within the legal profession.

Sometimes this reflects a lack of practical understanding of particular strategies and approaches – for example, a tendency to confuse stewardship or responsible investment approaches with ‘SRI’. When in 2009 PADA (the body that preceded NEST) consulted on what the incoming Trustee’s investment approach should consider, the response from the Association of Pension Lawyers mistakenly categorised its definition of a responsible investment policy as an ethically-driven ‘socially responsible investment’ approach. On this basis it went on to suggest that such a policy might be legally problematic: “it is perhaps fair to say that the law is still unclear where there is a conflict between the impact of such considerations and the return which trustees could earn from investing without regard to such factors... It would currently be a brave Trustee that does not take the view that financial performance was the primary criterion in setting investment options to observe even if it held particular ethical beliefs.”

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3 Buttle v Saunders [1950] 2 All ER 193
However, it would be a mistake to conclude that the only problem here is a lack of practical understanding: ‘stewardship’ approaches are often challenged by lawyers even on their own terms. The investment officer of one large pension scheme, who did not wish to be named, told us that they had received legal advice which cautioned strongly against the scheme’s industry-leading responsible ownership approach, repeatedly suggesting that it might be unlawful. The legal opinion even went so far as to question whether the exercise of voting rights was consistent with trustees’ fiduciary duties, suggesting that the costs associated with this activity would need to be weighed against the quantifiable benefits to the individual fund. The investment officer concluded: “If this is the advice that a large and well resourced fund like ourselves is receiving, I hate to think how small less experienced trustee bodies cope when presented with this kind of opinion.”

It is partly for this reason that we do not believe problems with fiduciary duty can be resolved solely by initiatives to promote understanding or best practice among pension fund trustees. These initiatives seem unlikely to succeed if decision-makers are still receiving contradictory legal advice. On p10 of our report we have already given some examples of the various - and mainly unsuccessful - attempts over the years to solve these long-standing problems without any statutory clarification of fiduciary duties. There is little evidence that the recent crisis has brought about the changes of attitude within the financial or legal worlds that might offer hope of spontaneous improvement in this respect. Explicit clarification of the law is one of the few interventions which seems likely to affect the advice given by lawyers, and thereby to address the ‘chilling effect’ of narrow interpretations of fiduciary obligation.

1.3 The tyranny of the model

It is striking that many of the Review’s interim findings – for example, regarding the desirability of investors focussing more on the quality of beta and less on chasing alpha – represent a fundamental challenge to prevailing economic wisdom and to the models on which institutional investors base their decisions. In our experience, the quality of beta (as opposed to the desirability of gaining exposure to beta through asset allocation) does not form part of the models most investors use to set their objectives and judge their performance.

Likewise, the ideal of a more engaged shareholder base investing in less diversified portfolios directly challenges the dictates of modern portfolio theory (MPT) that investors should seek maximum diversification in order to reduce investment risk. We are inclined to support the view that investing in a smaller number of companies allows for a greater degree of oversight, delivering a potential risk reduction to offset the theoretically greater risks of less diversification. There is also evidence that the benefits of diversification tail off rapidly as the number of stocks increase.\(^6\) However, Cambridge academic Rosy Thornton has effectively argued that trustees’ fiduciary duties consist in a slavish adherence to MPT, regardless of the materiality of the risk reduction achieved by greater diversification.

In arguing that the ‘ethical tie-break’ scenario is illusory, Thornton says that ‘even if... trustees genuinely find themselves unable to draw a line between proposed investments... the optimal decision would not be to choose one above the other, whether on SRI grounds or the toss of a coin, but (administrative costs permitting) to split the sum available for investment between both the assets and hence spread

\(^6\) See for example PADA, 2009, ‘Building personal accounts: Designing an investment approach’, p49
the hidden risk. If all else appears equal, then diversify.” This argument – which takes MPT to its logical extreme – clearly has implications which extend far beyond the narrow issue of ethical investment. It reflects what Steve Lydenberg, of Harvard University, has characterised as a shift from ‘reasonable’ to ‘rational’ interpretations of fiduciary duty\(^8\) – i.e. from the reasonable exercise of trustees’ independent judgement to the application of models to achieve an objectively optimal result.

Achieving the critical mass of long-term stewardship investors which the Review envisages requires a willingness among investors to take a much more sceptical attitude to prevailing models. Our proposed clarification of fiduciary obligation intends to encourage this willingness by empowering trustees to consider the wider range of factors that might determine whether a particular model is appropriate. However, we are aware that this by itself is unlikely to be sufficient to generate this cultural shift, and indeed that there is a wider question at stake – namely whether a more critical attitude to current models is sufficient, or whether the models themselves are unhelpful and ought to be superseded.

\subsection*{1.4 Use of contractual techniques to limit fiduciary obligations}

We agree with Hermes’ analysis, quoted in the report, of the fiduciary status of asset managers (“While on the face of it, fund managers are burdened with fiduciary duties through the simple fact that they are looking after money on behalf of others, not all accept the analysis, and in many ways the fiduciary duties are crowded out or limited by the specific terms of the contractual relationship”). However, it is important to remember that asset managers themselves are largely responsible for the terms of the contract, and so this observation in some ways reflects the wider problem of an industry failure to accept or apply fiduciary obligations.

One lawyer we spoke to said that it was a standard feature of almost all Investment Management Agreements he had negotiated to seek to exclude or restrict any fiduciary relationship between manager and client – although he also cast doubt on whether these attempts had any legal force. Other lawyers have expressed concern that pension fund clients, although treated as ‘sophisticated’ or ‘professional’ investors (and therefore subject to lower levels of regulatory protection, including from attempts by agents to exclude liability), may not be in a position to read or understand these contractual terms. It has even been suggested that terms relating to exclusion of fiduciary obligations are often hidden in obscure parts of the contract where trustees are unlikely to notice their significance.

Retail clients are protected by FSA rules from attempts to exclude or restrict any duties owed to them by their agents, including fiduciary duties.\(^9\) However, recent cases have exposed loopholes in this protection. The case of JP Morgan v Springwell ([2010] EWCA Civ 1221) confirmed that “two parties can agree that X is the case even if both know that it is not so”, thereby circumventing provisions to prevent the exclusion or restriction of liability. For example, a contract can state that their relationship is not a fiduciary one even if, factually speaking, it is. Legal provisions to prevent the exclusion of liability for breach of fiduciary duties are not engaged because the agreed contractual position is that those duties never existed in the first place.

\footnote{7\text{Rosy Thornton,} ‘Ethical Investments: A Case of Disjointed Thinking’, Cambridge Law Journal, 67(2), July 2008}


\footnote{9\text{FSA Conduct of Business Sourcebook 2.1.3}}
place. Slaughter and May have observed that this principle, known as ‘contractual estoppel’, has “evident potential for consumer detriment.”

2. Supplementary evidence on investor stewardship

2.1 Achieving a critical mass of ‘stewardship investors’

Section 3 of the interim report notes the view that changing patterns of share-ownership have altered the landscape when it comes to corporate actions such as takeovers. Differential voting rights are discussed as one possible means of ensuring that decisions about a company’s future are made by shareholders with a stake in its long-term success, rather than by arbitrageurs or speculators. We think this idea merits further exploration. Clearly, various practical issues would need to be resolved – for example, how one would treat a long-term shareholder who acquired additional shares after the announcement of a takeover bid – but these should not be insurmountable.

One other avenue for exploration would be whether it is possible to distinguish between ‘types’ of shareholder on grounds other than the length of time for which they have held their shares. For example, one could argue that commitment to the Stewardship Code defines a class of investors whose business models involve constructive engagement with investee companies, and it is this class of investors who should be given voting rights. Again, there are obvious practical problems with this approach – the Code’s comply-or-explain mechanism does not lend itself readily to measures which offer privileged rights to Code ‘signatories’. The Code itself would probably have to change in character somewhat if such an approach were adopted, but nevertheless it offers interesting possibilities.

These two approaches need not be mutually exclusive. For example, being a signatory to the Stewardship Code could be an additional requirement to that of being a long-term holder of shares. This would reduce the need for changes to the Code itself by mitigating the problems associated with its lack of a monitoring or enforcement mechanism. To be clear, we are not at this stage advocating differential voting rights, let alone any particular way in which these might operate. Nevertheless, we agree that this should no longer be a taboo topic.

However, it is also important to remember that, as illustrated by our previously submitted evidence, theoretically long-term investors such as pension funds may behave in a takeover situation in much the same way as ‘short-term’ investors, believing that it is their fiduciary duty to focus solely on the bid price rather than on the implications of the bid for the long-term success of the company. As such, even potentially radical and controversial measures such as differential voting rights could prove ineffective unless accompanied by measures addressed at the ‘long-term’ investors who would control decisions under such a system.

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2.2 Insurance companies and stewardship: findings of FairPensions’ survey

In 2011, FairPensions surveyed the top ten commercial pension providers on their approach to stewardship and responsible investment. Using NEST as a comparator, survey results suggested that contract-based pension providers lag significantly behind their trust-based counterparts.

- Only one company (Aviva) was a signatory to the UK Stewardship Code, and only one (AEGON) had a publicly available responsible investment policy. Aviva’s Stewardship Code statement was located on the website of its asset management arm, as opposed to its retail website.
- Monitoring of stewardship activity, where it took place at all, was generally restricted to internal asset managers: only Legal & General monitored their external asset managers’ voting activities, while none of those surveyed monitored external asset managers’ engagement activity.
- Most did not disclose voting information on their retail websites: where information was disclosed, it was generally restricted to the voting records of internal asset managers.

There was a general sense that most firms regarded themselves as platforms or ‘fund supermarkets’ rather than as asset owners with stewardship responsibilities. At our recent roundtable on insurance companies, participants – including those with extensive experience working with or inside the insurance industry – echoed this picture, describing investment governance at insurance companies as a ‘black box’. This is clearly a significant issue for the stewardship agenda as insurance companies grow in importance, with the decline of defined benefit occupational pension schemes and the advent of auto-enrolment likely to see them responsible for an increasingly large pool of assets.

3. Integrated reporting of ESG factors

The interim report references RPMI’s comments about excessive reliance by analysts on financial metrics rather than ESG and other qualitative factors, and solicits “ideas on how this should be developed within the general context of an approach which emphasises user driven information rather than data and prefers engagement to more extensive reporting as a means towards this end.”

We would like to offer some brief comments on this based on our experience of coordinating shareholder engagement on ESG issues. One of the key outcomes of 2010’s shareholder resolutions on oil sands was the disclosure by BP and Shell of their assumed carbon price. These disclosures came only after a considerable amount of dialogue and pressure on the companies concerned. Yet this is a critical piece of information regarding the companies’ management of a key risk to their business. Without it, it is difficult to see how shareholders could reach a fully informed judgement about the companies’ management of climate risk. This illustrates a general concern that too much engagement resource and activity is absorbed in generating disclosures which should be available as a matter of course, rather than in engaging substantively about the issues to which the disclosures relate.

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11 Full report available online at http://www.fairpensions.org.uk/stewardship-lottery; hard copies available on request.
Integrated reporting is fundamentally about ‘user-driven information’, since it aims to move from a model where environmental and social reporting is largely siloed in sustainability or CSR reports, with little relevance to the company’s core business, to one where ESG information that is material to shareholders is integrated into companies’ core reporting. However, we take it that ‘user-driven’ refers to information users need, rather than information they specifically request: investors cannot know what they do not know. Investors are expected to evaluate their investee companies’ prospects and to engage with them about how those prospects can be improved. If the information on which they must make these judgements is incomplete or misleading, it seems unreasonable to expect – as the current UK reporting regime does – that they will also be in a position to know and challenge this. Hence the need for certain minimum requirements to ensure that investors can rely on the information companies publish and that it gives a balanced and complete picture of key risks and uncertainties – including ESG risks.

Such a reporting framework need not set out extensive requirements for specific data that must be published, but it should guarantee that the information published is reliable. One of the most common reasons we hear why investors do not make greater use of non-financial information is its lack of reliability. To give a practical example, again drawn from our experiences in 2010, BP’s 2009 annual report cited oil demand projections which assumed no government action on climate change and a consequent 6 degree global temperature rise. These assumptions were not disclosed in the report. As well as being inconsistent with statements made elsewhere about the company’s strategy and approach to climate change, this was not accompanied by any discussion of how the company proposed to manage the risks to its business inherent in such a scenario – for example from extreme weather conditions. It is hard to imagine that such an approach would be considered acceptable in relation to financial projections.

This lack of reliability contributes to excessive reliance on short-term financial statements to the exclusion of a more qualitative assessment of the company’s long-term prospects. Improved reliability would seem to require either enhanced audit requirements (as was required by the Operating and Financial Review, which preceded the current Business Review) or more robust enforcement action by the regulator against incomplete or actively misleading reporting. It is regrettable that the UK government’s current review of narrative reporting has not taken the opportunity either to address the issue of reliability or to pursue the concept of integrated reporting. Further evidence on ESG reporting and our proposals for changes to the reporting framework can be found in our submissions to this consultation process.

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