‘Fiduciary Duties of Investment Intermediaries: Initial Questions’

Response from ShareAction

ShareAction welcomes this opportunity to respond to the Law Commission’s stakeholder paper on investment intermediaries’ fiduciary duties. In this response we have sought to collate the most important evidence and argument from our various publications on this subject, including:

- our annual industry benchmarking surveys
- our responses to the Kay Review’s calls for evidence
- our responses to other consultations by government and regulators

Below we respond to each of the bolded questions posed by the paper. In so doing we also address the questions posed regarding exclusion clauses and delegation. Where appropriate we have made reference to the publications listed above where further discussion or more detailed evidence can be found. We remain at the disposal of the Commission to discuss further any of the points raised in this response.

Who is subject to fiduciary duties?

Our perception of the current legal position is that:

- It is clear and undisputed that pension fund trustees have fiduciary duties to their beneficiaries.

- Those undertaking discretionary asset management on behalf of pension funds are likely to have fiduciary duties to the pension funds who are their clients. (This is not to say that they have direct duties to underlying beneficiaries which bypass their relationship with the client.) However, these duties may be modified by contractual terms.

- Consultants and others giving investment advice are likely to have fiduciary duties to their clients under common law.

- Insurance companies providing personal and stakeholder pensions are generally not thought to have fiduciary duties, but are often fulfilling very similar functions to the trustee.
boards of (particularly DC) pension funds: i.e. intermediating between savers and a series of funds run by professional asset managers.

However, in our experience there are some ambiguities and problems in market participants’ understanding of these duties:

- It is not always clear where the duties of pension fund trustees end and those of their asset managers begin. Statutory provisions protect trustees from liability as long as they have taken all reasonable steps to confirm that their agents have the necessary skills and are carrying out their work competently.\(^1\) It is not entirely clear what level of monitoring trustees must undertake to fulfil their fiduciary obligations, and to our knowledge this has not been tested in court. The trend towards ‘fiduciary management’ has only exacerbated this problem.

- In relation to asset managers’ own duties, it appears to now be widely accepted that asset managers have fiduciary duties to pension fund clients – although this was far from being the case when we first began working on this area, and were told unequivocally by senior representatives of pension funds that asset managers could not possibly be fiduciaries. However, we have concerns about the extent to which fiduciary standards are observed in practice. In defending the status quo, the asset management industry has a tendency to conflate necessary contractual modifications of fiduciary duty, of the kind which might equally apply to professional trustees (enabling the taking of fees, acting for multiple clients, etc), with the wholesale elimination of fiduciary duties via contractual techniques. Anecdotally, it appears that the latter is a standard feature of Investment Management Agreements (IMAs),\(^2\) despite the fact that asset managers routinely refer to themselves as fiduciaries. It is in this context that we have concerns about efforts to separate the ‘moral’ character of fiduciary duties from their legal content (see below).

- The notion that consultants have fiduciary duties does not appear to be generally accepted or to have a significant influence on behaviour. This matters because there is significant scope for conflicts of interest to arise in the giving of investment advice. For example, consultants may have incentives to advise pension funds towards complexity, since this necessitates more advice, but the costs associated with these more complex strategies may not be justified by better outcomes for beneficiaries. (For more on this, see page 11 below.)

- In relation to insurance companies, although the legal basis for the relationship with savers is different from a trust-based pension scheme, the economic relationship is very much the same. This disjunct may be problematic and has the potential to give rise to a ‘governance gap’ in contract-based pension provision. For example, our research suggests that insurance companies do not consider it part of their role to monitor and oversee external asset managers in the way that a board of trustees would do, believing that the responsibility rests with the individual saver who has chosen the product. Particularly under auto-enrolment, we would suggest that this assumption is unrealistic.\(^3\)

As an example of the practical implications of this uncertainty, many trustees assume it is the role of their asset managers to ensure that investment decisions reflect all material risk factors, including environmental, social and governance (ESG) issues. In a 2009 study by ACCA, trustees

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1 Pensions Act 1995: Section 34(4)
2 See for example clause 20.3 of the Investment Management Association’s precedent Investment Management Agreement.
made comments such as “It’s not our place as trustees to dictate to a manager... If these companies are at risk of not being sustainable as businesses, that’s for them to factor into their fundamental analysis.” The study concluded that “[trustees’] decision to delegate investment decisions to their fund managers has led to an impression that this frees them from a need to consider potentially material risk factors such as climate change.” Conversely, asset managers often appear to assume that it is up to trustees to explicitly instruct them to do this: in our 2009 survey, 56% of managers cited lack of client demand as a key barrier to greater integration of climate risk. Finally, surveys of consultants suggest a similar confusion over whether it is their responsibility to proactively raise ESG issues with clients, or simply to react to client demand. This lack of clarity potentially creates an impasse whereby nobody in the investment chain is taking responsibility for managing potentially material risks.

**Are fiduciary duties a ‘moral code’?**

We wholeheartedly agree with the Kay Review’s conclusion, articulated in the Commission’s paper, that fiduciary duties have value partly because they demand an ethic of care rather than a detailed set of boxes to tick. We note the famous statement of Judge Cardozo, in the American case of *Meinhard v Salmon*, that “a trustee is held to something stricter than the morals of the marketplace”. In our view this sentiment remains important and relevant: if anything, it is too often neglected in modern interpretations of fiduciary duty, which emphasise blind adherence to conventional investment models and treat the language of morality as an irrelevance to the objective pursuit of maximum profit.

However, as the Commission notes, we have expressed scepticism about some efforts to equate fiduciary duties with a moral code. Our concern is with industry rhetoric which uses ‘fiduciary’ language but attempts to separate this ethic of care from the legal content of fiduciary duties. As discussed above, in our view this muddies rather than clarifies the nature of the duties owed by commercial investment intermediaries. Indeed, we suspect that it is sometimes deployed precisely to divert the debate about fiduciary standards away from legal and regulatory reforms which might clarify or strengthen intermediaries’ obligations, and towards voluntaristic exhortations to change industry culture.

**What can fiduciary investors take into account?**

In each of the three areas outlined in the paper, our experience is that trustees (and their legal advisors) perceive the law as limiting their room for manoeuvre. Below we give examples of how current interpretations differ from this in relation to each of the three areas, before briefly setting out our own view of what the law requires.

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4 This is discussed on p65-66 of ‘Protecting our Best Interests’
5 For example, see FairPensions, 2009, ‘Preparing for the Storm? UK investment managers and the risks and opportunities of climate change’
7 *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928)
1) Environmental, social and governance (ESG) factors relevant to long-term financial performance

This is the area on which most progress has been made in recent years. The 2005 Freshfields Report\(^8\) has been influential in building support for the view that considering financially material ESG issues is part and parcel of trustees’ duty to protect beneficiaries’ financial interests. However, there remains residual uncertainty even on this issue, particularly among smaller schemes. Our general experience is that ESG integration has become relatively mainstream among asset managers, but is much less universally accepted among pension funds themselves. In our view this is partly down to the persistence of myths and misconceptions about fiduciary duty.

Shortcomings in theory: fiduciary duty as a barrier to ESG integration

In 2010 ShareAction co-ordinated shareholder resolutions at BP and Shell’s Annual General Meetings in relation to their Canadian tar sands projects. The resolutions were firmly centred on the implications for the firms’ long-term financial performance. They did not demand that the company pull out of the projects concerned, but merely asked for additional disclosures about their potential financial risks. We hosted a tool on our website enabling individual savers to email their pension funds asking about their stance on the resolutions. We asked these individuals to forward us any responses they received so that we could analyse the results.

Of 43 responses analysed, 11 made reference to the trustees’ fiduciary duties, in almost all cases as a factor militating against support for the resolutions. Some examples are given below:

- “The Trustees have a legal duty to not only invest, but to actively seek the best possible financial return … even if it is contrary to the personal, moral, political or social views of the trustees or beneficiaries. This was demonstrated in the Cowan v Scargill (1984) court case.”
- “We also have as our main duty the financial interests of our members and so must not be seen to be making decisions based on other criteria.”
- “You are reminded that the Fund has to balance the financial interest of the Fund with environmental considerations and throughout, it has a legal obligation to try not to compromise financial returns to the detriment of its membership.”

This suggests a continuing confusion between financially motivated ESG integration and ethically motivated ‘SRI’ strategies. As a result, fiduciary duty is still often regarded as a barrier to consideration of environmental and social issues, even if they might have financial impacts.

Interestingly, when we conducted a similar exercise in 2012 in relation to votes on executive pay, we found that fiduciary duty was much less frequently mentioned in funds’ responses. On the one hand, this suggests that executive pay (along with other governance issues) has become more widely accepted as a legitimate subject for investor concern, while environmental and social issues are still widely regarded as essentially non-financial. On the other hand, the failure to mention fiduciary duty at all suggests that the idea of a positive duty of stewardship has yet to gain traction.

\(^8\) Freshfields Bruckhaus Deringer, A legal framework for the integration of environmental, social and governance issues into institutional investment (October 2005). UNEP-FI.
Shortcomings in practice: do pension funds act as ‘universal owners’?

We have also found that acceptance of the case for ESG integration in theory does not always translate into full ESG integration in practice. We conduct annual benchmarking surveys of different segments of the industry, including asset managers and occupational pension funds. These consistently find that the number of investors paying ‘lip service’ to ESG integration is far greater than the number who show evidence of robust action in practice. Anecdotally, one reason for this appears to be that most pension funds do not regard ESG integration as a service for which they are willing to pay, meaning there is little commercial incentive for asset managers to devote significant resource to providing this service. Again, this suggests that many pension funds do not regard ESG risk management as part of their fiduciary duty to secure good financial returns for beneficiaries.

One particular area in which theory appears to lag behind practice is the concept of ‘universal ownership’, pioneered by James Hawley and Andrew Williams. This argues that, since pension funds are ‘universal owners’ with holdings across the economy, it is not in their interests for individual companies to make a profit by creating negative externalities, the costs of which are ultimately borne by other stocks in their portfolio. They also have a particular interest in the stability and sustainability of the financial system as a whole.

However, in our experience, most institutional investors are unwilling to act on ‘universal owner’ arguments. To return to the example of the tar sands resolutions, we found that investors were reluctant to engage with the implications of these projects for their portfolios as a whole (for example, through their disproportionate contribution to climate change). Instead they required a case to be made that the projects posed direct risks to BP and Shell, for example because of operational risks or the potential for carbon prices to rise.

Another example might be the banking crisis. Major banks’ excessive leverage and risky lending strategies had systemic impacts which have been devastating for pension fund returns. However, far from reining in these risky strategies in the run-up to 2008, most institutional investors actively encouraged them, on the basis that they were good for the short-term profitability of the individual banks. In the aftermath of the crisis, indications are of a return to business as usual. There appears to be limited recognition by fiduciary investors that what is good for individual banks may not be good for their portfolios as a whole.

In summary, there remains a widespread assumption that fiduciary duty only permits the consideration of ESG factors insofar as they affect profits at an individual company level. This is at odds with the conclusion of the Freshfields Report, and the dictates of modern portfolio theory, that investors’ fiduciary duties entail seeking good returns across their portfolios, rather than on a stock by stock basis.

2) Beneficiaries’ interests other than the maximisation of returns

Our overwhelming experience is that fiduciary investors do not feel able to consider factors outside of financial return. This applies both to (2) and to (3) below. However, in relation to ethical issues there is at least a relatively well-troddden debate: in contrast, issues like quality of life and wider economic interests are rarely discussed and do not appear to be on most fiduciaries’ agendas.

In discussions with the Commission we have already given the example of a large multi-employer fund seeking legal advice on whether, in voting on a takeover bid, they could take account of the fact that some of their beneficiaries might lose their jobs. The advice was that this would be an irrelevant consideration: the fund could only consider whether it was being offered a good price for its shares. Of course, a responsible fiduciary would need to balance this potentially devastating impact on a small number of beneficiaries against the potential financial benefits of the takeover – likely to be much less significant, but affecting a much larger group of beneficiaries. However, most beneficiaries would find it highly counter-intuitive that funds do not feel able to consider these impacts at all.

Another example would be the potential impacts of investors’ decisions on their beneficiaries’ quality of life. As the Freshfields Report put it:

“Many people wonder what good an extra percent or three of patrimony are worth if the society in which they are to enjoy retirement and in which their descendants will live deteriorates. Quality of life and quality of the environment are worth something, even if, or particularly because, they are not reducible to financial percentages.”

Climate change is a particularly relevant illustration of this. In addition to significant financial impacts, it is likely to affect many beneficiaries’ wider economic interests (for example, it is expected to bring higher food and fuel costs, which disproportionately affect pensioners) and their quality of life (for example, through more extreme weather). Yet fiduciary investors do not appear to feel that they can value these impacts. This may help to explain the relatively slow progress among institutional investors on integrating climate risks.

For example, in evidence to the UK Environmental Audit Committee, BT Pension Scheme explained:

“Based on current proposals for the issuance of green bonds, we would struggle to place them within our existing asset allocation and hence convince our Trustees to buy these. We have a fiduciary duty to invest in the most commercially competitive bonds after considering price, credit risk and liquidity. This means that any reduction in liquidity (inevitable given the small issue sizes envisaged) needs to be compensated by higher yields.”

We understand that this reflects the position of the Institutional Investors’ Group on Climate Change. Of course, we are not suggesting that fiduciary investors should disregard their usual investment criteria when considering green investments. However, this illustrates that the wider non-financial benefits to beneficiaries of investments in renewables are currently valued at zero – or, worse, are not considered to be relevant at all. Fiduciary duty is equated solely with seeking “the most commercially competitive assets” regardless of their wider impact, and is therefore regarded as a constraint on investments to mitigate climate change, rather than as a reason to seek out such investments.

Another example might be consideration of the impacts (positive or negative) of investments on the local community in funds where the beneficiary base is geographically concentrated, Strathclyde Pension Fund’s ‘New Opportunities Fund’ represents an attempt to use a small proportion of a pension fund’s assets to seek out investments which, while delivering a good return for savers, also

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10 Freshfields Bruckhaus Derringer 2005, op cit, p3
create decent local jobs or otherwise benefit the local economy. Spokesperson Colin Mackenzie has described the fund in terms of local authority pension funds’ “opportunity to use [their] money for the benefit of the local community”, whilst also stressing that “we have to deliver the return for members, so it’s not a bailout fund - the intention is to look for serious investments”.

However, this approach is very much the exception rather than the rule: many pension funds appear to believe they would be legally exposed if they actively sought out such investments. Local benefits are sometimes seen not as an added benefit for members but only as a source of conflict for politically motivated councillors (of course, they are potentially both: the important thing is that trustees can demonstrate a sound decision-making process rooted in beneficiaries’ interests). For example, Steve Dainty, pensions manager at Northamptonshire County Council, is quoted as saying: “We have to earn the best rate of return for our investors and we get people saying the Northamptonshire fund should invest in Northamptonshire infrastructure. As a pension fund manager I don’t like that as there is an immediate conflict of interest.” In the absence of clarification on what the law permits, such diversity of opinion seems unlikely to be resolved, and pension funds’ approach to this issue will inevitably be determined by the personal instincts of trustees and officers.

3) Beneficiaries’ ethical views and generally prevailing ethical standards

As with other non-financial considerations, in our experience the overwhelming consensus among UK pension funds is that they cannot make decisions on ethical grounds. This is reflected in a legal opinion given to USS by DLA Piper, on “the legal difficulties inherent in a policy of general exclusion of certain investments or categories of investment on social, ethical and environmental grounds”. The advice concludes that the expected financial performance of investments is the only criteria on which a pension fund may make investment decisions. Thus, while it may be legitimate for USS to ‘screen in’ investments which it expects to perform well by virtue of their ESG credentials, or to ‘screen out’ investments which it expects to perform poorly because of unethical practices, “the investment decision will have been driven by the relevant financially driven investment criteria, not by the influence of any extraneous moral consideration”. This conclusion appears to hold regardless of whether making ethical exclusions would have any negative impact on financial returns: according to DLA Piper, considering moral issues at all is simply impermissible.

The examples given above of pension fund responses to what they perceived as an ‘ethical’ issue (the tar sands resolutions at BP and Shell) also illustrate the prevailing view that fiduciaries are not permitted to take ethical considerations into account for their own sake. It is notable that the first of the three responses quoted conflates the distinction between financial and non-financial considerations with the distinction between trustees’ personal views and beneficiaries’ views – concluding (in our view, incorrectly) that case law prohibits trustees from having any regard to

15 Available online at http://www.uss.co.uk/Documents/Legal%20advice%20to%20USS%20on%20RI%20from%20DLA%20Piper%20Sept06.pdf
beneficiaries' ethical views. In our experience, this is not uncommon: trustees often rightly observe that their fiduciary duties prohibit them from indulging their own political or moral preferences at the expense of their beneficiaries, but wrongly infer from this that their beneficiaries' own moral preferences must also be ignored.

Elsewhere, the ‘duty to maximise returns’ is often invoked by funds as a reason to ignore members’ ethical concerns. For example, in 2011 Kent County Council responded to criticism of its investments in tobacco by saying that it had a “responsibility to obtain the best possible return on investments... To meet this responsibility, we do not impose restrictions on the companies that our external investment managers can or cannot invest in.”6 This response was echoed by other local authorities – for instance, Hackney Council stated: “The Council's Pensions Sub-Committee has a duty to maximise returns for its pension fund. As a result, our external fund managers will explore investing in a wide range of investment opportunities to ensure the committee’s responsibilities are fully met.”7

In 2012, ShareAction released a briefing with Action on Smoking and Health which was designed to prompt discussion about the extent to which local authority pension funds were free to make ethical exclusions, using tobacco as a case study.8 The briefing focussed on the concept of the ‘ethical tie break’, and was intended to move the debate on from simplistic claims that funds could not consider ethical issues, encouraging them instead to investigate the level of beneficiary concern and the extent to which this could be accommodated without compromising financial returns. Disappointingly, this was met with arguments very similar to those discussed above. For example, West Yorkshire Pension Fund responded to press enquiries with a statement that “the fund has a legal duty to maximise its investment returns .... When councillors are involved with a pension fund they act as trustees and their sole responsibility is to beneficiaries of the fund and they should not have any political influence.”9 In our view, this illustrates the resilience of current narrow interpretations of the law and suggests a need for clarification.

Recent developments in the US suggest that these narrow interpretations are at odds with the instincts even of many fiduciaries. In the wake of the Sandy Hook shootings, many pension funds have begun to consider disinvesting from gun manufacturers. It is quite clear that the reason for this is their sense that such investments are no longer morally acceptable to most beneficiaries. However, since prevailing interpretations of US law are very similar to those in the UK, these pension funds have generally felt obliged to dress up their decision in arguments about the future financial viability of gun manufacturers, for example due to the threat of increased regulation. Only a handful of voices have made a clear and explicit argument for a wider interpretation of fiduciary responsibility.10

**ShareAction’s view**

In our view, fiduciary investors should be empowered to exercise their discretion in determining what will best serve their beneficiaries’ best interests, as long as this is compatible with the primary purpose of the fund (i.e. for pension funds, to secure a decent pension) and with principles of prudent investment. This is reflected in the draft legislation published as part of our 2012 report.

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16 BBC News, August 22 2011
17 Hackney Citizen, August 18 2011
19 Yorkshire Post, January 25 2012
'The Enlightened Shareholder', which provides that fiduciaries may act on beneficiaries’ non-financial best interests as long as this does not materially compromise their financial best interests.\textsuperscript{21}

Notwithstanding the interpretations discussed above, we can find nothing in case law which is inconsistent with our view. Narrow interpretations of the law often cite Cowan v Scargill, and in particular its conclusion that in a pensions context, “the best interests of the beneficiaries are normally their best financial interests.”\textsuperscript{22} However, the judgment goes on to say: “I am not asserting that the benefit of the beneficiaries which a trustee must make his paramount concern inevitably and solely means their financial benefit.”\textsuperscript{23} The narrow reading of Cowan v Scargill was explicitly rejected by the judge in Martin v City of Edinburgh, who said “I cannot conceive that trustees have an unqualified duty… simply to invest trust funds in the most profitable investment available.”\textsuperscript{24}

In other words, non-financial considerations are not per se irrelevant, as concluded by the DLA Piper opinion discussed above. It is true that Cowan v Scargill goes on to stress that “the burden would rest, and rest heavy, on him who asserts that it is for the benefit of the beneficiaries as a whole to receive less”, but this is not what we are suggesting: the question is whether fiduciaries can consider non-financial issues absent a significant financial detriment. This principle has become known as the ‘ethical tie-break’, but it could equally be applied to the other non-financial issues discussed above under (2), in the form of a ‘social tie-break’ or similar. In a subsequent lecture, Sir Robert Megarry (the judge in Cowan v Scargill) suggested that this would be a very different situation from the rather extreme course of action proposed by the mineworkers’ union trustees. The judgment in Cowan v Scargill is in no way inconsistent with the adoption of a ‘tie-break’ approach to non-financial interests.\textsuperscript{25}

The question then becomes whether the ‘tie-break’ scenario is realistic. This is discussed further below in relation to diversification. Here we would simply point out that pension funds in some other jurisdictions appear to take a more common-sense approach to this question than is usual in the UK. For example, in Scandinavia, pension funds routinely exclude particular companies or sectors on ethical grounds.\textsuperscript{26} From speaking with such investors, we understand that this does not reflect an interpretation of the law in their jurisdiction which is radically different from our interpretation of UK law. On the contrary, they stress their duty to get the best return for pension savers, but believe that their ethical policies are consistent with this since they do not materially harm financial returns – in other words, the ethical tie-break scenario. This belief appears to be borne out by the performance of the funds concerned.

The same logic could be applied to other strategies, such as using a small proportion of a fund’s assets to seek out socially or environmentally beneficial investments. As long as this is done prudently, there is no reason to think that it must necessarily cause material financial harm to portfolio performance. The problem with current interpretations of UK law is that, for the most part, funds do not even consider whether this balancing act is achievable: the default assumption is

\textsuperscript{21} Available online at \url{http://www.fairpensions.org.uk/sites/default/files/uploaded_files/policy/EnlightenedFiduciaryReport.pdf}

\textsuperscript{22} Cowan v Scargill [1984] All ER 750; [1985] Ch 270. Page 760

\textsuperscript{23} Cowan v Scargill, Ibid, Page 761


\textsuperscript{26} See for example the ethical policy of the Norwegian Global Pension Fund, or of Danish funds such as PKA (discussed in ‘The Voice of the Beneficiary’).
that the pursuit of non-financial objectives is automatically off-limits. Of course, any such strategy would need to be based on a reasonable assessment of beneficiaries’ interests and values, and not simply the trustees’ own personal preferences or political agendas. (This was a major factor in the judgment in Cowan v. Scargill, and, to a lesser extent, Martin v. City of Edinburgh.) In ‘Protecting our Best Interests’ and ‘The Voice of the Beneficiary’, we consider how this can be put into practice whilst respecting the duty of impartiality.

As academics such as Steve Lydenberg point out, the beneficiaries to whom fiduciary duties are owed are not abstract ‘rational economic men’ but real human beings. To ignore their wider interests in a stable economy, sustainable environment and cohesive society is not to take a neutral position; rather, it reduces beneficiaries’ interests to their lowest common denominator. We are concerned that dominant interpretations of fiduciary duty replace the reasonable discretion of trustees with the false certainty of ‘objective’ financial models. The ability of such models to deliver for beneficiaries even on their own terms has been seriously called into question by the recent financial crisis: the status quo is consummately failing to produce impressive returns for pension savers.

Do fiduciary standards encourage ‘lemming’ behaviour?

The duty of prudence has historically been interpreted in relative terms, by reference to the behaviour of other ‘prudent’ investors. The classic statement of the prudent person rule in Re Whiteley reads:

“The duty of a trustee is ... to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide.”

Such a standard is necessarily relative to some extent. However, this relativity, and in particular the development of the standard into the ‘prudent expert rule’, often means that trustees feel obliged to follow conventional investment strategies, usually in the guise of recommendations made by their advisors. This may have been appropriate in the nineteenth century, when much of the relevant case law was laid down, but it is arguably not appropriate for large fiduciary investors in the twenty-first century, given our growing understanding of the systemic risks posed by markets with a tendency to herd. Moreover, when - as now - conventional approaches are based on short-term, benchmark-relative returns, ‘prudent’ investment becomes not the strategy which best accords with beneficiaries’ long-term interests, but potentially the reverse.

This dynamic has been explored by US academic Keith Johnson, who likens current interpretations of the duty of prudence to a ‘lemming standard’. The case of pension funds’ behaviour during the dot com bubble is an illustration of the lemming standard in action: we are aware that some pension funds sacked asset managers who correctly foresaw that the bubble would burst and therefore avoided investing in overvalued tech stocks. Because their peers were herding into these stocks, as long as the bubble continued to inflate, such managers under-performed their

28 Re Whiteley [1886] LR 33 Ch D 347
benchmarks. Pension fund trustees felt obliged to address this short-term under-performance even though it reflected a prudent long-term strategy that was in the interests of their beneficiaries.

More broadly, this may help to explain the predominance of benchmark-relative performance measurements, and presents a possible barrier to the implementation of the Kay Review’s recommendation that investors should focus more on long-term absolute performance. In general, interpretations of ‘prudent’ investing make the industry slow to change – although, paradoxically, they also make investors quick to herd into risky innovations when these are buoyed by a wave of market sentiment. Effectively, this means that innovations which somebody has a commercial incentive to promote are much more likely to be widely adopted.

Prudence has always been a dynamic concept, evolving from a focus on risk aversion (which originally barred fiduciaries from investing in equities and other assets deemed ‘speculative’)\(^\text{30}\) to a recognition of tenets of modern-day investing such as modern portfolio theory (MPT).\(^\text{31}\) In our view, the duty of prudence may now need to evolve again to recognise the influence of fiduciary investors as major market players, and to incorporate an understanding of systemic risks, which both the old and the new concepts of prudence are ill-equipped to deal with. The traditional assumption that risk could be minimised by avoiding ‘risky’ asset classes is clearly outdated. But the modern assumption that risk can be calculated and managed through diversification may be equally flawed.

Of course, fiduciary standards are far from being the only cause of herding and inattention to systemic risks. However, there is a case for saying that the law should seek to counteract these tendencies rather than exacerbating them. For example, investors could be explicitly permitted or encouraged to have regard to the impact of their decisions on financial stability and systemic risk. A more radical approach would be to recast the concept of prudence in terms of appropriateness to investment goals, rather than in relative terms based on the behaviour of other investors.

**Do fiduciary duties encourage too much diversification?**

In our view, prevailing interpretations of fiduciary duty may encourage excessive diversification. In addition to explicit statutory requirements to diversify, the perceived ‘duty to maximise return’ is generally interpreted in the context of modern portfolio theory (MPT), which emphasises the value of diversification in reducing portfolio risk. Thus, requirements which exist to prevent imprudent concentration of risk in a small number of stocks or sectors have been interpreted as preventing investors from limiting their exposure to anything less than the whole of the market. This mindset contributes to ever more complex investment strategies involving diversification not just within portfolios but across managers and mandates: for example, in 2010 the average externally managed pension fund had nine mandates, compared to just three a decade earlier.\(^\text{32}\) It is far from clear that the costs associated with this growing complexity are justified by superior performance.

The absolutist view of the fiduciary duty to diversify is expressed by Rosy Thornton in a paper on ethical investment. Thornton, following MPT, argues that the ‘ethical tie-break’ (discussed above) could never arise in practice, since “any restriction adopted on ethical or other grounds will necessarily have an effect, however small, upon efficiency”. Even if two assets did have identical

\(^{30}\) See for example King v Talbot, Re Whiteley, Harvard v Amory (notes 21, 22, 23) - discussed in ‘Protecting our Best Interests’, p17

\(^{31}\) See p17 of ‘Protecting our Best Interests’ for a full discussion of this.

characteristics in terms of both risk-adjusted returns and co-variance with the rest of the portfolio, the correct solution would be to split the investment equally between the two: Thornton’s mantra is “if all else fails, diversify.”

The main problem with this argument lies in Thornton’s own caveat, “however small”. Research suggests that the benefits of diversification tail off dramatically above around thirty stocks. It could therefore well be that the negligible extra benefit of holding a larger number of stocks would be less than the increase in long-term value which an investor might achieve by engagement as a more significant shareholder in a smaller number of companies. As such, a policy of maximum diversification may not always be in beneficiaries’ best financial interests.

Moreover, the financial crisis reinforced pre-existing concerns both about MPT as a technique at the individual portfolio level and about its perceived contribution to systemic risk. Slavish adherence to MPT may be leading fiduciary investors to neglect systemic risks against which traditional diversification is no shield, and which have potentially enormous impacts on beneficiaries (such as excessively leveraged banks, or climate change).

These factors have led to increased interest in other investment philosophies, such as holding concentrated, “stewardship” portfolios. An example would be Dutch asset manager PGGM’s Responsible Equity Portfolio. The Kay Review argues that more concentrated portfolios are an essential precondition of Professor Kay’s vision of a stewardship culture. Yet this cultural shift seems a very long way off in the UK. In our view it is possible that prevailing interpretations of the law are exacerbating this problem, since they appear to privilege the negligible gains of maximum diversification above the potentially more significant gains of better oversight in a smaller number of companies. Given the government’s stated support for the Kay Review’s recommendations, there might be value in some explicit confirmation that oversight of individual investments is part of a fiduciary investor’s role, and that if they hold so many stocks that meaningful oversight is impossible, the preferred solution should be to reduce diversification.

**Do fiduciary duties discourage stewardship?**

Properly understood, fiduciary duties should encourage stewardship rather than discourage it. As Professor Kay has pointed out, where equity investments are concerned the only thing which can ultimately produce long-term value for beneficiaries is well-performing companies, and – particularly for passive investors – active ownership is an important tool at investors’ disposal for ensuring that investee companies perform well.

Yet, for the reasons discussed above, current interpretations of fiduciary duty do still appear to hold back stewardship activity. This is less of a problem amongst the largest funds, where interpretations of the law are generally somewhat more sophisticated, at least when it comes to beneficiaries’ financial interests (i.e. recognition of the relevance of stewardship and of financially material ESG issues). However, we have heard trustees of smaller schemes cite fiduciary duty as a reason for not undertaking stewardship activity, usually on the basis that it is seen as a cost which is not justified by evidence of a demonstrable financial benefit to the fund. (To be clear, we are not

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suggesting that such funds should maintain internal resource for company engagement: this is an approach employed by only a handful of large funds. Rather, they should seek to appoint managers who display credible evidence of a robust stewardship approach. If they are too small even to do this, then it is likely they are in the category of funds identified by The Pensions Regulator as too small to serve their beneficiaries’ interests effectively.\footnote{See for example TPR, February 2011, ‘Enabling good member outcomes in work-based pension provision’, para 11 (p7); also discussed in ‘Protecting our Best Interests’, p44}

This links to the ‘free-rider problem’ inherent in stewardship activity: the benefits accrue to the market as a whole, while the costs are incurred by active investors. The prevailing interpretation of fiduciary duty exacerbates this collective action problem, since it equates the ‘benefit’ of beneficiaries with short-term monetisable benefit to the individual fund, and underplays the benefits of nurturing the health of the system, which may be less tangible but ultimately far more significant. For example, we are aware of one fairly large fund which received advice from a reputable law firm that its policy of voting all shares held could be unlawful unless it could demonstrate that this delivered a monetisable benefit. This ‘beggar thy neighbour’ approach to fiduciary duty undermines the incentive to engage in stewardship activity.

In our view, it is not coincidental that uptake of the UK Stewardship Code has been far greater among asset managers than among asset owners. For all but the largest pension funds, stewardship is certainly not seen as a positive obligation, and is often seen as incompatible with fiduciary duty. Our research has also found that insurance companies, who generally do not perceive themselves as fiduciaries, do not see stewardship as part of their role.\footnote{See FairPensions, 2012, ‘The Stewardship Lottery’, available online at http://www.shareaction.org/research/surveys} In other words, the idea that stewardship is part and parcel of fiduciaries’ duty to protect long-term value - although now mainstream within the corporate governance community - has yet to take root among asset owners.

**Are some permitted market practices incompatible with fiduciary duties?**

Yes. As the Commission’s previous review concluded, “there are many instances where regulatory rules permit... a lower standard of conduct than that required by fiduciary law.”\footnote{Law Commission, 1995, ‘Fiduciary Duties and Regulatory Rules’, (HMSO), para 1.8} This still appears to be the case. Market participants often point to FSA/FCA rules, and in particular to the requirement that a firm must “pay due regard to the interests of its customers” (Principle 6) and “manage conflicts of interest fairly, both between itself and its customers and between one customer and another” (Principle 8). However, these principles are quite clearly less stringent than the fiduciary duty of loyalty. As John Kay noted in a recent article in the Financial Times, “Fairness weighs competing claims and is appropriate for a referee, but not an agent: the honest intermediary does not balance the client interest with his own, but puts its client first.”\footnote{John Kay, 5 February 2013, ‘A ballboy, a union and bankers’ duty’, Financial Times. http://www.ft.com/cms/s/0/b692191e-6ec8-11e2-9ded-00144fcaeb49a.html} Of course, many examples of poor conflicts management would indeed fall foul of FCA rules, as demonstrated by the FSA’s recent ‘Dear CEO’ letter to asset managers on conflicts of interest.\footnote{FCA, November 2012, ‘Conflicts of interest between asset managers and their customers: identifying and mitigating the risks’, http://www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf} However, the fact that the asset management industry is failing to meet even regulatory standards should not distract us from the question of whether they ought to be subject to higher fiduciary standards.
Beyond Kay’s own example of income from stock lending, we can only speak about conflicts of interest in relation to shareholder engagement, since this is our area of greatest expertise. Here, our research suggests that the management of conflicts of interests leaves much to be desired. The conflicts of interest policies disclosed by many asset managers under the Stewardship Code are extremely light on detail;\(^{41}\) this has also been noted by the Financial Reporting Council. There is considerable anecdotal evidence that conflicts of interest do influence voting and engagement activity.\(^{42}\)

One small example from our own experience arose during the so-called ‘Shareholder Spring’, when some asset managers found themselves voting client shares in relation to controversial pay packages at their own parent companies. Aviva Investors was one such manager, but had published an exemplary conflicts of interest policy stating their procedure for voting shares in Aviva plc (they will not cast votes unless in accordance with explicit instructions from a client). By contrast, M&G discloses no such policy, and voted in favour of a controversial remuneration report at its parent company, Prudential.\(^{43}\) M&G’s voting disclosures provide no explanation as to how this conflict was managed or why they considered their decision appropriate. We suggest that this behaviour would not be acceptable from a fiduciary. We do not pretend that this example of poor conflicts management is particularly egregious, but intend it to serve as an illustration of what we suspect may be the tip of an iceberg.

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\(^{42}\) See for example S. Wong, ‘How conflicts of interest thwart institutional investor stewardship’, Butterworths Journal of International Banking and Financial Law, pp481-482, September 2011

\(^{43}\) For full details and links to the relevant conflicts of interest policies, see FairPensions, 2012, ‘The Missing Link: Lessons from the Shareholder Spring’, p10