

A Manifesto for Responsible Investment

and accompanying draft legislation

ShareAction 
the movement for Responsible Investment

About ShareAction

ShareAction is building a movement for responsible investment. We are the UK's leading civil society organisation promoting an investment system that better serves savers and the public interest. We believe that responsible investment helps to safeguard investments as well as securing environmental and social benefits.

We bring together leading charities, unions, faith groups and individual investors to scrutinise the big investors in our economy and to remove barriers to responsible investment. Our work with policy makers, regulators and parliamentarians is primarily designed to make the investment industry more accountable to savers. In 2012 we were named as one of the Observer's Brand New Radicals and we have twice been highly commended in the Charity Awards.

We are supported financially by a number of leading charitable foundations and by individual donations. A full list of our funders is available on our website along with details on our board of trustees, staff and member organisations.

As a registered charity, we warmly welcome donations to support the growing movement for responsible investment in the UK. If you would like to support our work financially please do so at shareaction.org/donate

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Acknowledgments

The creation of our manifesto has been a team effort, drawing on research and policy work by ShareAction over the last five years. Christine Berry, formerly of ShareAction, made an invaluable contribution, carrying out much of the original research that underpins the proposals in this document. The draft bill enclosed at the end of this document was written by Charles Scanlan, a long-time associate and supporter of ShareAction. We are enormously grateful to Charles for his hard work and for sharing his extensive legal expertise.

Our research and policy work has been funded for four years by the Nuffield Foundation. Nuffield's sustained support has been instrumental, allowing us to stick at the topics covered in this document and to engage in a detailed way with the most relevant policy and legal developments pertaining to responsible investment, notably the Kay Review and the Law Commission's Review of the Fiduciary Duties of Investment Intermediaries.

July 2014

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A Manifesto for Responsible Investment

Our vision is of an investment system which truly serves savers, society and the environment. Today's market fails to do that.

The stakes are high. UK pension funds alone already control £2.9 trillion in assets, while automatic enrolment is bringing 10 million more working people into the nation's private pension system. There is an urgent need to ensure that the system works.

Long-term institutional investors have enormous potential to act as providers of patient capital and as responsible owners of businesses at home and abroad; to lead the transition to low-carbon prosperity; and to promote socially sustainable wealth creation.

But, as the last decade has made clear, our investment markets are dysfunctional and failing in their core purpose of allocating capital effectively.

Too few of the institutional investors looking after other people's money are properly engaged with the long-term drivers of business success that matter most. In particular, the investment system routinely overlooks the twin challenges of environmental sustainability and social inequality, although both have profound implications not just for long-term investment returns but for the future well-being of today's pension savers.

A significant cause of the problems we see is the absence of incentives for large investors to act in the best interests of the savers whose money they manage. Our Manifesto for Responsible Investment makes the case for a more accountable investment system, featuring opportunities for greater scrutiny and participation by savers themselves. Improving accountability to savers is not just right in principle; it is a vital component in solving the problems in our current system. The changes we propose would encourage individuals and institutions looking after our savings to refocus their attention on what matters to us.

The specific policies we advocate fall into two broad areas: firstly, we propose measures to better protect savers' interests over the timeframe that counts in the pensions sector. Our recommendations on this are set out on page 5. Second, we propose a series of measures to achieve greater accountability in the investment system. Recommendations on this are set out on page 6.

Individually the measures proposed are modest and require no public spending. Taken together, we believe they would catalyse the cultural change in investment markets that has been called for so often over the last twenty years.

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Why Responsible Investment Matters

The behaviour of large institutional investors matters to all of us: to people in their capacity as savers, as workers and as citizens; to businesses of all sizes; and to the preservation of our environment.

A recent YouGov/UKSIF survey found that 53% of the public want pension funds to engage with companies to ensure they pay their fair share of tax and 48% want pension funds to ensure that executive pay and bonuses are not excessive. Despite these expectations, people's trust in professional investors is weak. The CFA Institute found that just 7% of retail investors believe that investment firms "do the right thing". A lack of public trust is damaging to the fortunes of the investment sector and could jeopardise the success of pensions policy over the long term.

For individual businesses and for the competitiveness of British industry, the short-term outlook of many large investors is deeply unhelpful. Directors of large companies are aware of the growing risks to business performance posed by environmental and social issues, but corporate action to address those risks is constrained by an investment system that overwhelmingly values factors that drive share prices in the very short term. A survey by Accenture and the UN Global Compact found that 86 per cent of CEOs want investors to more accurately value sustainability in their long-term investments. Policy measures to promote responsible and accountable behaviour by institutional investors will help to drive business success in the UK and beyond.

Although our pension system's core purpose is to help us prepare for the future, the current system is curiously blind about what that the future holds. Climate change is arguably the single biggest threat to the world economy. Our pension funds should be powerful allies in the fight to address it. But, whilst some funds are starting to engage in a serious way with the risks and investment opportunities presented by climate change and other resource constraints, the great majority still invest on the assumption that the future will look just like the past. That position is imprudent. The policies in our Manifesto would help to focus the minds of those in charge of our long-term savings on the critical challenge of climate change.

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The Case for Legislation

Alongside our Manifesto for Responsible Investment, we have prepared details of legislative interventions, including a draft Responsible Investment Bill, to illustrate how our specific policy proposals might be enacted.

We favour primary legislation as the most effective means of definitively addressing the real and perceived legal obstacles to responsible and accountable investment. Other methods, such as guidance and statements by government ministers, have been tried but have failed to bring about the degree of behaviour change that is needed, not least to protect the new generation of savers coming into the system through pensions automatic enrolment.

In demonstrating how the measures in our Manifesto would apply in practice, we have restricted our bill drafting to occupational pension funds. However the issues of trust and accountability that these reforms seek to address are relevant across all types of pension provision and in other savings vehicles used by the public. Indeed, we are concerned that members of contract-based pension schemes are not subject to the same legal protection as those in trust-based schemes. There is a clear need to ensure that pension savers receive the same level of protection regardless of the form of their pension arrangements.

The Responsible Investment Bill enclosed in this document provides a fiduciary investor version of section 172 of the Companies Act, which defined the duties of company directors, in terms which reflected the concept of 'enlightened shareholder value'. Accordingly, the Responsible Investment Bill makes clear that the primary duty of a pension fund is to pursue financial return. But the bill also confirms that in carrying out its investment and stewardship functions, a pension fund may have regard to such matters as:

- i) the likely long-term consequences of its investment activities
- ii) environmental, social and governance considerations
- iii) the beneficiaries' broader welfare or future quality of life and
- iv) the beneficiaries' views, including but not limited to their ethical views.

As with section 172 and company directors, this section of the Responsible Investment Bill would provide absolute reassurance to a pension fund wanting to pursue responsible policies that it is permissible, indeed desirable, to do so. Furthermore, defining the duties of pension funds in this way should help to improve the working of section 172 itself. Put simply, a system of enlightened shareholder value is more likely to flourish if we encourage the emergence of enlightened shareholders.

ShareAction believes that trustee discretion is an important feature of the current pensions landscape. Our emphasis in the bill is on empowering fiduciaries to act in the enlightened interests of their beneficiaries, not on imposing restrictive regulations.

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Manifesto Proposals

Protecting savers' long-term interests

The law should impose clear duties on all those managing savers' money to act responsibly in their long-term best interests.

Fiduciary duties exist for this purpose, but there are three key problems with the current situation:

- Among those who have fiduciary duties (such as pension fund trustees), interpretations of the law are frequently dysfunctional. The recent Law Commission review of this issue acknowledged these problematic interpretations and agreed that the law is 'confusing and inaccessible' and 'not well known'. Fiduciary duty is invoked to justify behaviour which may actually damage savers in the long-term, such as neglect of ownership responsibilities or sustainability factors. This is usually done on the grounds that fiduciary duty is a 'duty to maximise returns'; yet the weak returns being reaped by savers suggest that this concept is not delivering even in the short-term.
- A growing proportion of the pensions industry is not subject to fiduciary duties at all, but instead is covered by FCA rules imposing materially weaker standards. For example, while pension trustees have a strict duty to prioritise the best interests of the savers whose money they manage, FCA rules only require insurance companies that offer pension products to 'balance' the interests of pension savers with those of the firm.
- Finally, the current legal position appears to require pension providers to behave 'dishonourably' in order to protect members' interests. It is unhelpful that the law gives the impression that high standards of behaviour in investment are disallowed.

ShareAction recommends:



All pension providers should **owe a duty to scheme members** to act in their best interests.



Explicit legislative clarification to confirm the Law Commission's conclusion that pension trustees are **not legally obliged to chase short-term profits and ignore wider considerations**. This principle should also apply to other pension providers.



The law should permit pension providers to **act according to prevailing standards of reputable behaviour** and to act in members' long-term best interests when it comes to **collective action problems** (including but not limited to the risks posed by climate change).

A more accountable investment system

Savers should be guaranteed rights to scrutinise decisions made on their behalf.

The rise of private pension savings has led to a ‘democratisation’ of company ownership. This originally led to optimistic predictions of a new form of capitalism, in which shareholder-owned enterprises effectively had a mandate to answer to ordinary people. But there was a problem with this theory: in practice, large investors, including pension funds, responsible for other people’s money are not answerable to the individuals whose funds flow into capital markets. Although much has been done in recent years to make companies more accountable to their shareholders, policymakers have yet to take the logical next step of making institutional investors themselves more accountable to the people whose money they manage.

For example, savers have limited rights to information about what their money is invested in, how shareholder rights are exercised on their behalf, and how their pension fund is implementing its investment policies. Their rights to participation – either by proactively being consulted about fund policies, or by retrospectively holding fund decision-makers to account for their decisions – are virtually non-existent.

ShareAction recommends:

- » Pension savers should have the right to know **where their money is being invested** and **how pension funds are exercising shareholder rights** on their behalf. This should include making voting disclosure mandatory by pension funds and other institutional investors.
- » In the same way that companies are obliged to provide investors with forward-looking annual reports detailing their strategy and risks, pension savers should have access to annual reports explaining **how their fund has implemented its investment policy over the year**, and **how it is managing future long-term risks to their money**.
- » Pension savers should have **the right to question the people who look after their money** by attending annual meetings, in the same way that companies are obliged to hold annual meetings for their shareholders. They should also have the **right to be consulted on investment and voting policies**.
- » Savers should have the **right to elect representatives** to the board or governing committee of their pension fund and to stand for election themselves.

Draft Responsible Investment Bill

A BILL TO make provision for responsible and accountable long-term investment by institutional investors; and for connected purposes.

This draft bill is intended to serve as an indicative working document to promote discussion on the issues which arise from it, with a view to arriving at a consensus among stakeholders as to the need for primary legislation to promote responsible long-term investment and as to the precise scope of any such legislation. The draft has been worded with that purpose in mind, rather than as an attempt at detailed parliamentary drafting.

As an aid to easier reading, all defined terms in the draft are shown in italics, with the related definitions being found in Clause 12 (with the exceptions of “fiduciary investor” and “investor”, which are defined in Clauses 11(1) and 11(4) respectively).

In relation to the long bill title, it may be helpful to outline here the main themes of the draft bill:

First, the bill envisions a fairly “high level” Responsible Investment Act that would clear away any obstacles (real or perceived) under existing common law and that would provide a framework for more detailed changes, which would be made either by statutory instrument or through changes to the FCA Rulebook. It is envisaged that the whole package of primary and secondary legislation would come into force on the same date: a “Responsible Investment Day”. (It is likely that many of the regulations would be made under already existing primary legislation, including the Pensions Acts and the Companies Act, rather than under the new Act.)

Second, the bill follows the general approach adopted in previous ShareAction (FairPensions) publications, including “Protecting Our Best Interests: Rediscovering Fiduciary Obligation” (2011), “The Enlightened Shareholder: Clarifying investors’ fiduciary duties” (2012) (which contained specimen draft legislation for a fiduciary investor equivalent of section 172 of the Companies Act 2006) and “Our Money, Our Business: building a more accountable investment system” (September 2013).

In essence, we propose retaining the core fiduciary principle of undivided loyalty to the beneficiaries but call for a broader interpretation of beneficiaries’ “best interests” and for more accountability to, and participation by, beneficiaries. Further, whilst high standards are demanded of fiduciary investors, the aim is also to repose trust in them in relation to the exercise of their discretions: the emphasis is on empowering fiduciaries to act in the enlightened interests of their beneficiaries, not on imposing restrictive regulations. The corollary is that, for this approach to work, fiduciaries need to have the requisite expertise and resources and to be free from inherent conflicts of interest.

In drafting the bill we have taken into account (among other sources) relevant recommendations in the “Kay Review of UK Equity Markets and Long-term Decision Making: Final Report” (July 2012) and the Government’s Response “Ensuring Equity Markets Support Long-term Growth” (November 2012) and the Law Commission’s report “Fiduciary Duties of Investment Intermediaries” (July 2014).

Be it enacted [etc] as follows –

1. Duty to act in the best interests of the beneficiaries and related powers

(1) In the performance of any *investment functions* a *fiduciary investor* must act in the way the *fiduciary investor* considers, in good faith, would be most likely to be for the *benefit* of the *beneficiaries* as a whole and to be fair as between the *beneficiaries*, including as between present and future *beneficiaries*. In doing so, the *fiduciary investor* is empowered to have regard (among other matters) to:

- (a) the likely consequences of any *investment activities* in the long term,
- (b) the impact of any *investment activities* on the financial system and the economy,
- (c) social and environmental considerations, including
 - (i) the implications of social and environmental factors for return on *investments*, and
 - (ii) the impact of any *investment activities* on communities and the environment,
- (d) the implications of any *investment activities* for *beneficiaries'* quality of life, and
- (e) the views, including the social and ethical views, of *beneficiaries*.

(2) A *fiduciary investor* shall take all reasonable steps to ensure that all of its delegates and advisers who are *fiduciary investors* comply with this section.

(3) In relation to a *fiduciary investor* who is a delegate of or adviser to another *fiduciary investor*, this section shall take effect subject to the terms of any mandate or instructions under which the delegate or adviser is performing *investment functions*.

Explanatory Notes

Clause 1 may be seen as the core of the bill.

Clause 1(1) is intended to be a fiduciary investor's equivalent of section 172 of the Companies Act (Duty to promote the success of the company). It is designed to complement and improve the effectiveness of that section in fostering long-termism and reinforcing the broader interpretation of promoting "the success of the company for the benefit of its members as a whole" that is set out in the section.

Clause 1(1) is an amended version of the earlier draft contained in The Enlightened Shareholder, referred to above. Reference should be made to that publication for a detailed explanation of the thinking behind the wording of the clause and of the related definitions (in clause 12) of "benefit", "best interests" and "investment functions", which (despite some differences in wording) have not been fundamentally altered in this draft.

*However, a key point to note here is that "benefit" (and the effectively synonymous "best interests") is defined so as to allow fiduciary investors to have regard to "benefit" of any kind, so long as this does not risk 'significant financial detriment' to beneficiaries. This enables a fiduciary investor to take into account considerations such as "beneficiaries' quality of life" and their "social and ethical views", as referred to in Clause 1(1). The "significant financial detriment" test is derived from the judgment in the leading case of *Harries v Church Commissioners* and is endorsed in the Law Commission's report.*

*A further point to note is the duty under this clause "to be fair as between the beneficiaries, including as between present and future beneficiaries". This wording is derived from similar wording in the judgment in another leading case, *Cowan v Scargill*. It encapsulates two core concepts: the duty of impartiality and the principle of intergenerational equity.*

Clause 1(2) requires a fiduciary investor to take reasonable steps to ensure that any other fiduciary investors further down the investment chain are complying with the duties under Clause 1(1), insofar as these apply to them. This wording is also used in later clauses in relation to other duties under the bill and is

intended to help counteract the tendency for asset owners, for example, to confuse delegation of functions with abdication of responsibilities. This is particularly important as the bill envisages that end-beneficiaries' interests will be protected by back-to-back contractual arrangements throughout the investment chain rather than by giving beneficiaries direct rights of enforcement against trustees' delegates and advisers (See below under Clause 8).

Clause 1(3) makes it clear that delegates and advisers take their lead in these matters from the scheme trustees, as "top fiduciary".

2. Duty to ascertain *beneficiaries'* views

(1) A *fiduciary investor* shall be under a duty to take all reasonable steps to ascertain the views of *beneficiaries* in relation to any matters pertaining to its *investment functions* (and in particular, but without limitation, any views on the general principles governing investment or stewardship policies) in order to be able to exercise its power under section 1 to have regard to those views in the performance of its *investment functions*.

(2) A *fiduciary investor* shall have full discretion as to the procedure it adopts in order to discharge its duty under this section.

(3) Without prejudice to the generality of subsection (2) –

(a) where under section 8 its duties under this Act are owed directly to the *beneficiaries*, a *fiduciary investor* may seek to discharge its duty under this section by direct consultation or dialogue with the *beneficiaries* or with their elected or appointed representatives, and

(b) in any other case, a *fiduciary investor* may seek to discharge its duty under this section by ascertaining the views of *beneficiaries* from the person to whom it directly owes its duties under this Act.

(4) In having regard to the views of *beneficiaries*, a *fiduciary investor*, acting in accordance with its duty under section 1 to be fair as between *beneficiaries*, shall have full discretion to balance or prioritise various views or concerns among the *beneficiaries* and, in the case of opposing views, may (but shall not be bound to) adopt what it considers to be the most widely held or expressed view, provided that, in relation to social and ethical views, the adoption of a particular view would not, in its judgment, risk significant financial detriment to *beneficiaries*.

(5) Nothing in this section shall be interpreted as giving *beneficiaries* any power to direct or instruct a *fiduciary investor* in the performance of its *investment functions* or as in any way restricting its discretion in that regard.

Generally, Clause 2 is intended to strike a balance between the duty to seek to ascertain beneficiaries' views and giving fiduciary investors the maximum degree of discretion to apply that principle in accordance with the particular circumstances of each individual case.

Sub-clause (4), in particular, is designed to address common objections to the desirability or feasibility of reflecting potentially diverse beneficiary views in investment or stewardship policies. It also confirms that fiduciary investors may have recourse to the so-called "ethical tie-break" (or the equivalent "social tie-break"), based on the (no) "significant financial detriment" test referred to above under Clause 1.

The wording of sub-clause (4) reflects the principle that the fiduciary's duty of impartiality applies as much to these kinds of "benefit" as to benefits of a purely financial nature (as where the investment policy has to balance the differing interests of older and younger beneficiaries).

Although the handling of ethical and "quality of life" issues is specifically referred to in sub-clause (4) in order to clarify the law on this controversial question, it should be noted that Clause 2 as a whole relates to the ascertainment of beneficiaries' views in relation to "any matters" pertaining to the fiduciary investor's investment functions and it is likely that beneficiaries' financial concerns will predominate.

Clause 2 would apply both to the operation of any collective investment fund and to the selection by trustees of different funds (including ethical or green funds) as investment options to meet beneficiaries' individual preferences.

(6) The Secretary of State may by regulation prescribe procedures which *fiduciary investors* may choose to adopt in pursuance of their duty under this section and such regulations may provide that any *fiduciary investor* that follows a prescribed procedure shall be presumed to have discharged that duty, but such regulations shall neither require any *fiduciary investor* to follow any prescribed procedure nor otherwise restrict its discretion under subsection (2).

(7) A *fiduciary investor* shall take all reasonable steps to ensure that all of its delegates and advisers who are *fiduciary investors* comply with this section.

(8) In relation to a *fiduciary investor* who is a delegate of or adviser to another *fiduciary investor*, this section shall take effect subject to the terms of any mandate or instructions under which the delegate or adviser is performing *investment functions*.

3. Duties of accountability and transparency

(1) A *fiduciary investor* shall be under a duty to account for all its *investment activities* and shall also be under a duty to act transparently in that regard.

(2) A *fiduciary investor* shall comply with any reasonable request for information relating to the performance of its *investment functions*, where such request is made by the person to whom its duties under this Act are directly owed or by or on behalf of one or more of the *beneficiaries* (whether or not its duties under this Act are directly owed to the *beneficiaries*).

(3) For the purposes of this section, a request for information shall be presumed to be reasonable unless

(a) the requested information has already been supplied to the person making the request within twelve months before the date of the request; or

(b) the requested information is otherwise readily and freely available in easily comprehensible form to the person making the request and that person has been advised accordingly; or

(c) the costs of providing the information would be disproportionate, having regard to the *best interests* of the *beneficiaries* as a whole and to whether the requested information is relevant to those *best interests*, and the *fiduciary investor* has stated that to be its view and has given its best estimate of such costs to the person making the request; or

(d) there are commercial considerations, including (without limitation) confidentiality constraints, that, for so long as such considerations subsist, would make it either unlawful or not in the *best interests* of the

Here again, this clause imposes duties on fiduciary investors but also gives them some discretion where they consider that requests for information are not reasonable. It should be noted, though, that the test of reasonableness under sub-clause (3) is an objective one, not ultimately dependent on the opinion of the fiduciary investor.

Despite the general approach of the bill that beneficiaries' rights are enforceable against the scheme trustees rather than against their delegates or advisers, there is a case for requiring intermediaries further down the investment chain to respond to requests for information that come direct from beneficiaries, as provided in sub-clause (2). In particular, this might be where trustees have delegated their investment powers to investment managers and then use this as an excuse not to provide information. The need to make such a request could be an indication that the chain of delegation and accountability is broken. Indeed, one would expect beneficiaries to exercise this right against delegates and advisers only where their trustees had failed to respond properly to their initial requests.

This extra element of direct accountability could also contribute to an essential change of culture, under which investment intermediaries would be mindful of their duties to act in the best interests of real beneficiaries rather than for an abstract "fund".

Under the rule in Re Londonderry's Settlement, referred to in sub-clause (4), trustees are not obliged to give reasons for the exercise of their discretions.

beneficiaries for the *fiduciary investor* to give the requested information, and the *fiduciary investor* has stated that to be its view and, so far as practicable, has indicated the nature of the relevant considerations to the person making the request.

(4) A *fiduciary investor* shall comply with any reasonable request for information relating to the reasons for the manner in which the *fiduciary investor* has exercised or is proposing to exercise a discretion in the performance of its *investment functions*, notwithstanding any common law rule or equitable principle, including (without limitation) the rule known as the rule in *Re Londonderry's Settlement*, that might otherwise permit or require the *fiduciary investor* not to disclose those reasons.

(5) A *fiduciary investor* shall take all reasonable steps to ensure that all of its delegates and advisers who are *fiduciary investors* comply with this section.

4. Duty to avoid conflicts of interest

(1) A *fiduciary investor* must wherever possible avoid a situation in which the *fiduciary investor's* interests conflict, or possibly may conflict, with the interests of *beneficiaries*.

(2) The duty under subsection (1) is not infringed -

(a) if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest; or

(b) in such circumstances as may be prescribed in regulations under subsection (4).

(3) In the event of an actual or possible conflict of interest between a *fiduciary investor* and *beneficiaries*, whether or not arising in circumstances that are an infringement of the duty under subsection (1), the *fiduciary investor* shall, as soon as possible, disclose the conflict to the person or persons to whom the duty is owed and shall manage the conflict in the sole interest of the *beneficiaries*.

(4) The Secretary of State may by regulation provide that, in prescribed circumstances, where an actual or possible conflict of interest arises by reason of a *fiduciary investor's* commercial or corporate relationship with another party (including, without limitation, a corporate relationship with a company in which the *fiduciary investor* is an investor) the *fiduciary investor*

This rule evolved in the context of private trusts with a view to avoiding family disputes or embarrassments. It is, therefore, generally inappropriate to pension schemes, where the beneficiaries have paid for their benefits and, in private trust terms, are also the "settlers".

It should be noted, however, that sub-clause (4) relates only to discretions exercised in the performance of "investment functions", as defined in Clause 12: it would not apply, for instance, where scheme trustees were exercising a discretion as to the disposition of a lump sum death benefit among eligible beneficiaries. In such circumstances, scheme trustees are acting in much the same way as the trustees of a family trust: in both cases, the trustees are often guided by a written expression of wishes from the "settlor". There is no inconsistency here: on the contrary, the common theme is to give effect to the property rights of the "settlers". In other words, this is a further reminder that, in a pension scheme, this is the beneficiaries' "own money".

Sub-clauses (1) and (2) (a) are, broadly, based on sub-sections (1) and (4)(a) of section 175 of the Companies Act (Duty to avoid conflicts of interest). This clause also reflects the references to conflicts of interest in the Good Practice Statements for Asset Managers and Asset Holders in the Kay Review. (The wording of the clause is, however, arguably stricter than the corresponding wording in the Government's Response (page 9), although this was said to reflect the Statements).

The requirement in sub-clause (3) that conflicts be managed "in the sole interest" of the beneficiaries follows the wording of The Occupational Pension Schemes (Investment) Regulations 2005 (reg 4(2)), which in turn gives effect to the IORP Directive (Article 18(1)(a)).

Sub-clauses (4) and (5) are an attempt to deal with (among other sources of conflict) the problem of business models that have inbuilt conflicts of interest. One solution to the problem would be to prohibit such models but that is beyond the scope of the bill.

Sub-clause (6): there is a case for the bill to cover perverse incentives specifically, as these are perhaps the most important factor driving short-termism and other investment practices that are contrary to the best interests

shall be deemed not to have infringed the duty under subsection (1) by reason only of the existence of that relationship.

(5) Regulations under subsection (4) may further provide that any such relaxation of the duty under subsection (1) as is described in subsection (4) shall have effect for a specified period only, pending the termination or prohibition of such conflicted commercial or corporate relationships.

(6) For the purposes of this section, *short-term remuneration incentives* for *fiduciary investors* or their employees may constitute an actual or possible conflict of interest.

(7) A *fiduciary investor* shall take all reasonable steps to ensure that all of its delegates and advisers who are *fiduciary investors* comply with this section.

5. Power to act according to *prevailing standards of reputable behaviour*

(1) A *fiduciary investor* may act in accordance with *prevailing standards of reputable behaviour*, whether or not that is in the short-term financial interests of the *beneficiaries*, if it considers that to do so would be in the *best interests* of the *beneficiaries*.

(2) This section shall have effect notwithstanding any common law rule or equitable principle to the contrary, including (without limitation) the rule known as the rule in *Buttle v Saunders*.

of the ultimate beneficiaries. For example, investment managers who are remunerated in this manner will be less likely to be motivated to question similar arrangements within investee companies – or to be taken seriously if they do. (See here the related definition of “short-term remuneration incentives” in Clause 12).

This clause reflects, to some degree, the Kay Review’s conclusion that the correct approach would be “not to require, or even permit asset holders or asset managers to depart from generally prevailing standards of decent behaviour even if such behaviour would not be in the narrow financial interest of the beneficiary”.

Buttle v Saunders, referred to in sub-clause (2), was the case in which trustees were held to have a duty to “gazump”.

In its terms of reference, the Law Commission was asked to evaluate “the extent to which fiduciaries may, or must, consider ...generally prevailing ethical standards, and / or the ethical views of their beneficiaries, even where this may not be in the immediate financial interest of those beneficiaries”. The wording of Clause 5 is, we believe, broadly consistent with the views expressed on this question in Chapter 6 of the Law Commission’s report, particularly when read with Clause 2 (Duty to ascertain beneficiaries’ views). None the less, there remains a strong case for explicit clarification of the law on this issue.

(See the related definition of “prevailing standards of reputable behaviour” in Clause 12.)

6. Power to act in beneficiaries' enlightened self-interest: collective action problems

(1) If a *fiduciary investor* considers that a particular policy relating to any of its *investment functions* would, if generally adopted by market participants, contribute to the solution of a *collective action problem* that affects the *best interests* of the *beneficiaries*, the *fiduciary investor* may unilaterally adopt that policy if the *fiduciary investor* considers that to do so would not risk significant financial detriment to the *beneficiaries*.

(2) A *fiduciary investor* may act in accordance with subsection (1) whether or not it is possible to quantify the effect of the policy or the extent to which any benefits of the policy would accrue to the *beneficiaries*.

(3) In deciding whether to act in accordance with subsection (1) a *fiduciary investor* shall be under no obligation to refrain from so acting in the hope or expectation that other market participants will adopt the policy or otherwise contribute to the solution of the *collective action problem* without cost to the *beneficiaries*.

(4) This section shall have effect notwithstanding any common law rule or equitable principle to the contrary.

7. Scope and nature of powers and duties of fiduciary investors

(1) The powers and duties of *fiduciary investors* specified in this Act are, subject to some amendments, based on certain common law rules and equitable principles as they apply in relation to the powers and duties of investors acting in a fiduciary capacity and the specified powers and duties have effect in place of such of those rules and principles as would otherwise apply to persons who are defined as *fiduciary investors* under section 11.

(2) The powers and duties specified in this Act shall be interpreted and applied in the same way as common law rules or equitable principles, and regard shall be had to any corresponding common law rules and equitable principles in interpreting and applying those powers and duties.

(3) The consequences of breach (or threatened breach) of any duty specified in this Act are the same as would apply if the corresponding common law rule or equitable principle applied and such duties are, accordingly, enforceable in the same way as any other fiduciary duty.

(4) The duties specified in this Act are independent of any regulatory

This clause is designed to rescue long-term investors - and, through them, their beneficiaries - from a "tragedy of the commons". It makes clear that they are under no duty to follow a policy of "rational" selfishness or to be free-riders.

Taken together, Clauses 5 and 6 are designed to help bring about much the same societal benefits as might be specified under a full "stakeholder" system (where investors would owe direct duties to third parties) but without departing from the principle of undivided loyalty to the beneficiaries and its attendant accountability.

(See the related definition of "collective action problem" in Clause 12.)

With regard to sub-clause (4), common law barriers to the kinds of action authorized by Clause 6 could include certain remarks in the judgment in Cowan v Scargill relating to benefits that are "too remote and insubstantial"; these are referred to in Chapter 6 of the Law Commission's report (albeit in the context of purely financial benefit). As with Clause 5, it appears that Clause 6 is compatible with the view of the law expressed by the Law Commission but this is perhaps more doubtful; accordingly, the case for statutory clarification is even stronger.

This clause draws on Chapter 2 of Part 10 of the Companies Act 2006 (General Duties of Directors) (sections 170 – 181) and in particular on section 170 (Scope and nature of general duties) and section 178 (Civil consequences of breach of general duties).

The Companies Act provisions replaced the common law fiduciary duties of directors with the statutory general duties. The draft bill also imposes duties on fiduciary investors and sub-clause (1) broadly follows sub-section (3) of section 170 in providing that the statutory duties replace any corresponding common law fiduciary duties that would otherwise apply. (There is some difference in the wording to reflect the fact that in some cases the fiduciary investor (as defined in the bill) may not be already subject to fiduciary duties under the common law, whereas company directors undoubtedly were.

Sub-clause (2), relating to the interpretation and application of powers and duties under the Act, is based on sub-section (4) of section 170.

requirements under any enactment to which a *fiduciary investor* may be subject, including (without limitation) any regulations relating to investment or to disclosure of information to *beneficiaries*, and, accordingly, the duties shall not be limited by such requirements.

8. Persons to whom the duties of *fiduciary investors* are owed

Notwithstanding the requirement under section 1 for all *fiduciary investors* to act in the *best interests* of the *beneficiaries*, the duties of *fiduciary investors* specified in this Act are owed directly as follows -

- (a) in the case of persons described in section 11 (1) (a) (trustees of a trust scheme), to the *beneficiaries* of the trust scheme;
- (b) in the case of persons described in section 11 (1) (b) (trustees' investment delegates), to the trustees of the trust scheme or, in the case of sub-delegates, to the immediate delegator;
- (c) in the case of persons described in section 11 (1)(c) (trustees' investment advisers), to the trustees of the trust scheme or, in the case of sub-contracted parties, to the other party to the contract; and
- (d) in the case of persons described in section 11 (1) (d) (further designated *fiduciary investors*), to the person specified in regulations under section 11 (2) in accordance with section 11(3).

9. No contractual or other exclusion of duties or powers

- (1) The duties and powers of *fiduciary investors* under this Act cannot be excluded or restricted by any instrument or agreement.
- (2) In this section, references to excluding or restricting a duty include –
 - (a) making the duty or its enforcement subject to restrictive or onerous conditions;
 - (b) excluding or restricting any right or remedy in respect of a breach of duty, or subjecting a person to any prejudice in consequence of his pursuing any such right or remedy; and
 - (c) excluding or restricting any rules of evidence or procedure.

Sub-clause (3), relating to the enforcement of duties under the Act, is based on section 178.

Sub-section (4) (which has no equivalent in the Companies Act) is intended to ensure that the principles of the Act will remain fully applicable irrespective of any other regulatory provisions which might otherwise be interpreted as replacing or restricting them. This is designed to strengthen the overarching nature of the Act and to provide some protection against future regulatory capture.

This clause is based on the principle that, although all fiduciary investors are under a duty to act in the best interests of the beneficiaries, the duty is only owed directly to -and enforceable directly by - the beneficiaries in the case of the "top fiduciary" (for example, scheme trustees); in other cases, the beneficiaries' interests are protected indirectly by back-to-back contractual arrangements throughout the investment chain. Here again, the importance of having an effective and non-conflicted top fiduciary is evident.

An alternative (or supplementary) approach would be to consider ways in which end-beneficiaries could be given direct rights against intermediaries further down the investment chain.

Sub-clauses (1) and (2) give effect to the recommendation in the Kay Review that the duties of investment intermediaries should not be subject to contractual overrides (Recommendation 7). The wording draws on that of section 33 of the Pensions Act 1995, which prohibits any exclusion or restriction of trustees' or fund managers' duty of care in relation to investment functions.

Sub-clause (4) is specifically concerned with the common wording of pension schemes that was designed to comply with the pre-Finance Act 2004 tax regime. More generally, however, it reinforces the ability to have regard to the broader purposes of a pension scheme indicated in Clause 1, including the promotion of a good quality of life for beneficiaries in their retirement.

(3) In this section, references to excluding or restricting a power include making the exercise of the power subject to restrictive or onerous conditions.

(4) Any provision in any instrument to the effect that a pension scheme to which the instrument relates is established for the sole purpose of providing financial retirement benefits shall be interpreted so as not to exclude or restrict any of the powers conferred by this Act, including (without limitation) the powers under section 1, and any related provision in any such instrument limiting the exercise of any power to amend the pension scheme shall be similarly interpreted.

10. No effect on wider powers

Nothing in this Act shall be interpreted as affecting any provisions in any instrument or agreement that confer on a *fiduciary investor* any wider powers than those conferred by this Act, including (without limitation) any powers to invest in accordance with any ethical or other non-financial criteria in priority to financial considerations.

11. *Fiduciary investor*: definition

(1) In this Act “*fiduciary investor*” means any of the following persons or institutions –

(a) the trustees of a trust scheme as defined in section 124(1) of the Pensions Act 1995;

(b) any person or institution to whom the trustees of a trust scheme have delegated any of their *investment functions* and any sub-delegates, in relation to the performance of such functions only;

(c) any person or institution whom the trustees of a trust scheme have appointed to advise or assist them in the performance of any of their *investment functions* and any sub-contracted party, in relation to the giving of such advice or assistance only; and

(d) any person or institution designated in regulations under subsection (2) as a *fiduciary investor*, either generally or in relation to prescribed *investment functions* only.

(2) The Secretary of State may by regulation

(a) designate further categories of persons or institutions as *fiduciary investors* either generally or in relation to prescribed *investment functions* only;

This section confirms the established principle that express authorisation in a trust instrument can override general rules of law relating to investment. This principle was confirmed in the Law Commission’s report (paragraph 6.87)

Clause 11(1) defines “fiduciary investor”, the class of market participants to which the bill is to apply.

Clause 11(2) provides for regulations to add new categories of “fiduciary investor” (whether wholly new entities or existing fiduciary investors in respect of additional roles) and for these categories to be changed from time to time (but not so as to narrow the original definition in the Act).

The following points should be particularly noted here:

First, the initial list of fiduciary investors is limited to the trustees of occupational pension schemes, their investment delegates (e.g. investment managers) and advisers (e.g. investment consultants).

As currently drafted, therefore, the bill does not attempt to deal with the vexed issue of the governance of contract-based schemes and, in particular, the question of whether it is realistic to try to devise structures for such schemes that will give beneficiaries a level of protection that is comparable to fiduciary standards, given the conflicts of interests between providers and beneficiaries. This should not, however, be taken as a permanent acceptance that full

(b) provide that where, by virtue of subsection (1), a person or institution is a *fiduciary investor* in relation to prescribed *investment functions* only, that person or institution shall be designated as a *fiduciary investor* in relation to further prescribed *investment functions* or generally;

(c) provide that where, by virtue of regulations made under paragraph (a) or (b), a person or institution is designated as a *fiduciary investor* either generally or in relation to prescribed *investment functions* only, that person or institution shall no longer be so designated, provided that no such provision shall restrict the scope of subsection (1); and

(d) make any ancillary provisions.

(3) Where regulations under subsection (2) designate as a *fiduciary investor* any person or institution not previously so designated in subsection (1) or in regulations made under subsection (2), the regulations shall also specify the person to whom the long-term investor directly owes its duties.

(4) For the avoidance of doubt, in this Act “investor” includes any person or institution performing any *investment functions*, including those of an advisory nature only, and “*fiduciary investor*” shall be interpreted accordingly.

(5) In this Act, references to a *fiduciary investor’s* delegates or advisers shall be interpreted as including respectively sub-delegates or sub-contracted advisers and references to sub-delegates or sub-contracted advisers shall be interpreted as including respectively sub-delegates or sub-contractors of any degree.

fiduciary (or fiduciary-like) standards of protection should not be extended to the beneficiaries of all pension schemes, whether trust-based or contract-based.

The bill has been drafted so that its application could be extended if, for example, there were to be a policy decision to move to a wholly trust-based UK pension system, similar to the Australian model detailed in the Consultation Paper for the Law Commission Review. Such a move could include statutory provisions to bring the “legacy” of existing contract-based schemes under some form of (wholly independent) fiduciary oversight. There would, therefore, be no reason for delaying the enactment of a Responsible Investment Act on the grounds that it was not immediately of universal application.

Second, as indicated above, the most obvious persons to which paragraphs (b) and (c) of Clause 11(1) would apply are investment managers and investment consultants respectively. However, under the present fairly general wording, other delegates and advisers could be included, particularly given the wide definition of “investment functions” in Clause 12: for example, proxy voting agencies or custodians. As this project develops, more detailed policy decisions would need to be made regarding precisely which other market participants should be included or excluded from the scope of the bill. (For instance, the position of legal advisers would need to be clear.)

Third, in relation to investment consultants, the Law Commission’s report has raised doubts as to whether reform of the rules relating to “generic advice” is possible, given the provisions of MiFID (paragraphs 11.61 and 11.62). This was despite the fact that the “great majority” of consultees favoured reform (paragraphs 11.51 to 11.57). Clearly, this question will demand further consideration. We would, however, make the initial point that the application of “high level” fiduciary principles to investment consultants which is envisaged in the bill would not of itself require generic advice to “fall within the scope of FCA regulation”, in the words of the Law Commission (paragraph 11.50).

Lastly, the bill does not extend beyond pension savings. It can be argued that pensions are a special case, especially with the advent of auto-enrolment. There is, though, also an argument for extending the scope of the bill to other forms of long-term savings (for example, ISAs or long-term insurance contracts). That could be achieved subsequently by regulations under sub-clause (2). Here again, however, this would seem to require the establishment of an appropriate fiduciary structure.

12 Interpretation

In this Act -

“beneficiaries” means persons for whose *benefit investments* are being, will be or may be applied, whatever the particular form of ownership under which *investments* are held for the time being.

“benefit” includes –

- (a) financial benefit provided out of *investments*; and
- (b) any other benefit (including without limitation any *non-financial benefit*) which a *fiduciary investor* considers can be conferred on *beneficiaries* without a risk of significant financial detriment

and **“best interests”** shall be interpreted accordingly.

“collective action problem” means any disincentive to collective action in pursuance of common interests, including any conflict between the shared interests of market participants and their individual interests. For this purpose, *collective action problems* may relate (without limitation) to stewardship of *investments* in specific companies in which there are co-investors or to systemic threats to the financial markets, the economy or the environment.

“investment activities” means any actions taken in the performance of any *investment functions*.

“investment functions” includes (among other matters) such of the following as pertain to the particular description of *fiduciary investor*–

- (a) the selection, retention and realisation of *investments*,
- (b) the stewardship of *investments*, including (without limitation)
 - (i) the exercise of rights, including voting rights, attaching to *investments* and
 - (ii) engagement with the managers of investee companies and other investee entities in relation to (among other matters) corporate governance (including management remuneration) and corporate actions,
- (c) the selection, appointment and monitoring of investment managers and other agents to whom the *fiduciary investor* delegates any *investment functions*,

- (d) the selection, appointment and ongoing review of any investment funds which are operated by insurance companies or other institutions acting as principals and in which the *fiduciary investor* invests,
- (e) the selection, appointment and monitoring of investment consultants and of other advisers in relation to the performance of any *investment functions*,
- (f) advising or assisting another *fiduciary investor* in relation to the performance of any *investment functions*,
- (g) ascertaining the views of *beneficiaries* in relation to the fiduciary investor's *investment activities*; and
- (h) collective action with other market participants to further any common interests.

“investments” means the investments in relation to which any *investment functions* are performed and, where the context admits, includes assets of any kind representing such investments.

“non-financial benefit” means any *benefit* relating to any non-financial concern including (without limitation) any of the factors listed in paragraphs (b) to (e) of section 1(1) (whether or not any such factor also has financial implications), provided that the *fiduciary investor* has good reason to believe that *beneficiaries* would share the concern.

“prevailing standards of reputable behaviour” means standards which a *fiduciary investor* considers to be in accordance with generally prevailing norms of socially acceptable and responsible behaviour relating to business ethics, to environmental, social or governance issues or to other matters, including (without limitation) any such norms set out in international conventions, voluntary codes of practice or otherwise.

“short-term remuneration incentives” means remuneration arrangements that relate to the performance of *investment functions* and that may be reasonably considered to be likely to incentivise the person remunerated thereunder to prioritise short-term investment performance over long-term, sustainable value creation or to be otherwise contrary to the *best interests* of the *beneficiaries*.

Supplementary Regulations

To achieve our vision of an accountable and responsible investment system, several regulatory changes would be required to compliment the primary legislation outlined in our draft Bill. An illustrative proposal on the necessary regulatory changes is outlined below. ShareAction's publication "Our Money, Our Business" contains a fuller exposition of the case for these proposals.

Statements of Investment Principles (SIP)

The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378) states that trustees of occupational schemes must prepare a Statement of Investment Principles. Amongst other things, this statement must cover:

'the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments; and their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to the investments'

In line with the Law Commission's recommendations in their review of fiduciary duties, we recommend that the government reviews this regulation. The present very general, tentative wording of the regulations allows, indeed encourages, trustees and their advisers to adopt anodyne, generic wording. This has two adverse consequences; trustees can easily avoid serious consideration of environmental, social, and stewardship issues; and policies are often so vague, it is usually impossible to tell whether or not they have been followed. The SIP should be posted on the scheme website, in a clearly accessible place.

Disclosure of Information

The Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 (SI 2013/2734) should be amended to improve accountability and transparency. Reactive accountability can be improved through displaying contact details for investment related queries clearly on the website and disclosing the major shareholdings on at least an annual basis. To improve proactive accountability, schemes should be required to hold annual meetings providing members with an opportunity to meet their trustees and ask questions relating to decisions made with their savings.

This regulation's requirement for occupational pension schemes to produce an annual investment report should be amended so that the report more closely resembles companies' narrative reports, focussing on how the scheme has implemented its investment policy during the year and managed long-term risks. It should also give details of any conflicts of interest that arose in the investment chain and how these were managed. Again, the report should be on the scheme's website.

Voting Disclosure

The Government should exercise its reserve powers under section 1277 of the Companies Act to make voting disclosure mandatory for institutional investors, at least in relation to those who are defined as fiduciary investors.



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