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# Draft High-Level Principles of Long-term Investment Financing by Institutional Investors

## Comments from ShareAction

### About ShareAction

ShareAction (formerly FairPensions) is the UK's leading charity monitoring and engaging with institutional investors. Our goal is an investment system that serves savers, society and the environment. In particular, we work to encourage effective management of environmental, social and governance (ESG) risks, and active stewardship of listed companies through the informed exercise of shareholder rights.

ShareAction also champions greater transparency and accountability to the millions of people whose long-term savings are entrusted to the capital markets. We are a member organisation and count amongst our members a growing number of globally recognised NGOs and trade unions, as well as over 8000 individual supporters.

We were a key contributor to the Kay Review of UK Equity Markets and Long-term Decision Making, and our research on investors' fiduciary duties informed Professor Kay's recommendations in this area.[1]

### General comments

We welcome many aspects of the draft principles, in particular:

- the reference in the preamble to the desirability of "reducing turnover within portfolios and thereby costs" (para 7);
- the wording of Principle 1.1 regarding government policy, especially the reference to considering "wider potential public impact, societal returns and externalities, while ensuring its consistency with the best interest of members, beneficiaries, policyholders and other relevant stakeholders";
- several aspects of Principle 3, especially the references to managing conflicts of interest, addressing ESG risks, and evaluating fund managers' performance over the long term;

[1] See for example FairPensions, 2011, 'Protecting our Best Interests: Rediscovering Fiduciary Obligation', FairPensions, 2012, 'The Enlightened Shareholder: Clarifying investors' fiduciary duties'

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- the discouragement of "excessive or mechanistic reliance on external information providers" (Principle 4.1).

## Definition of long-term investment

We welcome the Preamble's association of long-term investment with "patient, productive and engaged capital" (although what is meant by these terms could be explained more fully, rather than only by reference to the relevant discussion paper). In our view, it is important the long-term investment is understood as a mindset rather than a particular set of assets or asset classes. Whether an institution is behaving as a long-term investor is not a question of what percentage of their portfolio they are allocating to infrastructure or other "long-term assets", but of how they approach their responsibilities across the *whole* of their portfolio. The words 'patient, productive and engaged' are helpful in summing up this mindset.

However, this could be carried through more strongly to the principles themselves. At present there is too strong a focus on encouraging allocations to particular types of investment, such as infrastructure: the Principles often refer to "long-term assets", although it is not clear how this term is defined. Against this backdrop, wider questions of long-term risk management sometimes appear to be an afterthought. For example, Principle 3.5 refers to the management of "any risks associated with long-term assets as well as any long-term investment risks – including environmental, social and governance risks – that may affect their portfolios." Whilst the reference to portfolio-wide risks is welcome, it should be the primary focus of this Principle rather than being subordinated to consideration of the particular risks applying to illiquid assets.

## Agency problems

As the Kay Review highlighted, at present there are significant structural problems with the investment industry – for example, agency problems and excessively frequent benchmark-relative performance monitoring – which militate against long-term investment. There is therefore a need for a significant shift in culture and also potentially in industry structure. This is acknowledged in the OECD's 2011 discussion paper,[2] which states that "a new investment culture is needed" and that "the market, by its nature, is unlikely to deliver such a change". However, this acknowledgement does not extend to the Draft Principles, which focus on ensuring the uninhibited functioning of the market – for example, paragraph 10 of the Preamble states:

*"The principles address primarily regulatory and institutional impediments to long-term investment by institutional investors and aim to avoid interventions that may distort the proper functioning of markets."*

Where the Principles do refer to agency problems, the wording is sometimes vague or unclear – for example, Principle 3.8 states:

*"Regulatory and supervisory authorities... should monitor the governance, agency relationships and risk management mechanisms underpinning long-term investment and take prompt and adequate measures when relevant."*

[2] Della Croce, Stewart & Yermo, 2011, 'Promoting Longer-Term Investment by Institutional Investors: Selected Issues and Policies'

However, it is unclear what is meant by “prompt and adequate measures”: what sort of measures are envisaged and with what objectives? When might they be ‘relevant’?

## Stewardship

Greater recognition of the problem of investor short-termism would also change the focus of the Principles in relation to stewardship and engagement. At present, stewardship only appears to be dealt with by Principle 3.6, which links the discharge of fiduciary duties to “the informed and effective use of … shareholder rights, including voting rights”. This wording is welcome and important: in the UK we have witnessed some confusion among asset owners over whether ensuring the exercise of shareholder rights falls within their remit as fiduciaries. However, as the Kay Review noted, the need is not just to promote more shareholder engagement but more effective and responsible engagement. Prior to the financial crisis, many investors actively encouraged banks to pursue more highly leveraged and therefore more immediately profitable business strategies. Institutional investors were not merely an absent force for long-termism but an active force for short-termism.

We would therefore suggest that stewardship and engagement be given greater profile in the Principles, and be framed explicitly in terms of promoting more long-term and responsible engagement. Stewardship should ideally be given a Principle of its own, which should include, for example:

- confirmation that engagement should focus on long-term risks, including ESG risks, and not simply short-term financial results;
- encouragement to investors to recognise their role as ‘universal owners’ with holdings across the economy, and therefore to engage with investee companies where their activities may pose long-term *systemic* risks; and
- confirmation that institutional investors should disclose their voting records and should report to clients and beneficiaries on engagement activities.

## Long-term investment and sustainability

The Preamble’s reference to the “urgent need to address the challenge of climate change”, and the reference in Principle 1.5 to “green growth”, is extremely welcome. Understanding and addressing environmental risks is critical to long-term investing. A growing body of research shows that climate change poses enormous long-term financial risks to institutional investors. More generally, recent work by the UK Actuarial Profession on the implications of resource constraints has begun to quantify the highly significant risks to long-term investors from ignoring environmental limits.[3] At a policy level, the challenges of overcoming short-termism and promoting sustainable investment are intrinsically interlinked.

It is therefore disappointing that this wording in the Preamble and in Principle 1 is not carried through to the rest of the Principles. In our view there would be value to a principle explicitly encouraging investors to consider the financial and environmental sustainability

[3] The Actuarial Profession, 2013, ‘Resource constraints: Sharing a finite world. Implications of limits to growth for the actuarial profession’.

of their investments, to integrate sustainability metrics into their investment decisions, and to develop clear policies for addressing the risks posed by climate change to their beneficiaries. The OECD's 2011 discussion paper says that "responsible investors should ... ensure that they understand and integrate appropriately environmental risks, such as climate change, in their investment and risk management strategies, promoting long-term risk management in the companies they invest in". In our view, similar wording could usefully be imported into the principles themselves.

There would also be value to a principle encouraging governments to create the conditions for sustainable investment, for instance by promoting better non-financial reporting by companies, and by ensuring policy certainty regarding investment in green technologies.

## Governance and fiduciary duty (Principle 3)

We welcome the reference to fiduciary duties in Principle 3, and in particular the confirmation that "those persons and entities involved in the management of the assets of institutional investors should act in consistency with those fiduciary duties". (In our view, such persons and entities will themselves often have fiduciary duties towards the institutional investors who are their clients.) However, in our view the concept of fiduciary duty is given insufficient profile and attention, and Principle 3 as a result feels muddled.

For example, Principle 3.1 refers to the "prudent person principle", while principle 3.4 refers to the need to address "conflicts of interest". These are both core elements of investors' fiduciary duties. Indeed, all elements of Principle 3 could be seen as aspects of investors' fiduciary duties. Yet fiduciary duty is not referred to until Principle 3.6, at which point the reference to "prudent" investment is repeated.

We would suggest that the content of Principle 3.6 be moved to the beginning of Principle 3, and that the wording and content of this section be substantially refined:

- Explicit reference should be made to investing in the best interests of the ultimate owners or beneficiaries, since this principle is at the heart of fiduciary obligation.

- Explicit reference should be made to institutional investors' duty of impartiality as between beneficiaries, and in particular to the implications of this for long-term investment: institutional investors should ensure that they are acting impartially as between younger and older beneficiaries. As academics such as Keith Johnson have argued, short-term investment strategies may fail investors' duty of impartiality towards younger savers with longer time horizons. This may be exacerbated by the tendency for older beneficiaries to be over-represented on trustee boards.[4] Proper consideration of the duty of impartiality would promote longer investment horizons.

- The reference to managing conflicts of interest in Principle 3.4 should be amended to read: "The governing body of institutional investors should ensure that conflicts of interest that may affect their investments <u>are identified and avoided wherever possible."</u> It is a key principle of fiduciary obligation that conflicts of interest should be avoided in the first instance, rather than simply managed.

Our research has shown that, in the UK at least, fiduciary duties are often misinterpreted as obliging investors to monitor performance on a quarterly basis and to respond to short-

[4] See in a UK context TUC, 2008, 'The Member Voice in Pensions Governance'

term fluctuations in performance.[5] This is currently being addressed at a UK level by the Law Commission, following a recommendation of the Kay Review. Anecdotally, we understand that similar problems exist in other OECD countries. Paragraph 10 of the Preamble states that "government can create appropriate framework conditions for long-term investment", while Principle 1.4 states that "governments should create the necessary legal and institutional preconditions for the development of institutional investors with a longer term investment horizon". In our view, one crucial way in which governments can do this is to ensure that the law poses no real or perceived impediment to investors attending to long-term risks which may not be immediately monetisable. We would therefore favour the insertion of a principle to this effect.

## Pro-cyclicality and herding behaviour (Principle 3)

The OECD refers to the desirability of avoiding pro-cyclical behaviour by institutional investors. However, the Principles do not address the issue of 'herding', which is a key driver of pro-cyclical behaviour. They also make reference at several points, in Principle 3 and elsewhere, to "prudent" investment. Narrow interpretations of the prudent person principle are an important driver of herding behaviour. 'Prudent investment' is generally interpreted as investment which follows the behaviour of other similar investors. This makes fiduciary investors wary of departing from the herd even when the consequences of following the herd may be objectively worse for their beneficiaries. Keith Johnson has referred to this as a 'lemming standard'.[6] It also contributes to an excessive focus on relative performance, as opposed to absolute performance.

For example, the 2011 discussion paper states that institutional investors "should normally rebalance their portfolios when asset price bubbles develop". However, interpretations of the prudent person principle mean that in fact the opposite is often the case. We are aware that, during the dotcom bubble, some pension funds actually sacked asset managers who recognised the bubble and avoided technology stocks, because they were departing from the herd and therefore underperformed their peers in the short term. This was clearly not a genuinely prudent or long-term decision.

To address this problem the Principles could:

- insert an explicit statement in Principle 3 that the prudent person principle should not be applied or enforced in a way which encourages excessively pro-cyclical behaviour; and

- explicitly discourage institutional investors from relying on benchmark-relative returns to measure their performance.

## Disclosure (Principle 7)

Transparency to the ultimate owners of capital is an important mechanism for promoting long-term, responsible behaviour by institutional investors. As stated in the OECD Guidelines for the Protection of the Rights of Members and Beneficiaries in Occupational Pension Plans:

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[5] See footnote 1

[6] Johnson, K. 2010, 'Back to the Future of Pension Fund Trust Fiduciary Duties' (available online at www.fairpensions.org.uk/sites/default/files/uploaded_files/KeithJohnsonFiduciaryDuty.pdf)

*"Adequate disclosure, in addition to helping to effectuate the substantive and procedural rights of members and beneficiaries, may also lead to more effective pension plan governance by enabling members to monitor certain aspects of plan administration".*[7]

We therefore welcome the inclusion of principles relating to disclosure under Principle 7, but would urge that these be strengthened, and greater priority given to disclosure to clients and beneficiaries (as opposed to the exchange of information between government, regulators and investors). In our view, the most effective way of guaranteeing this is to promote public disclosure. This also helps to protect the significant public interest in long-term, responsible behaviour by major institutions.

Principle 7.3 refers to disclosure on the "extent to which [investors'] investment strategies are in line with their investment horizon" and the "extent to which they address long-term risks". This is welcome in principle, but the phrasing is problematic since it implies that these things are optional. In carrying out their fiduciary duties, institutional investors *must* manage long-term risks and ensure that their investment strategies are in line with their investment horizon. It therefore seems odd to demand disclosure of "the extent to which" they do this. This principle should be amended to refer to disclosure of *how* investors manage long-term risks and align their strategies with their investment horizons, rather than simply *whether* they do this.

Principle 7.4 focuses on disclosures regarding the assets invested in. We welcome this in principle. However, the wording implies that 'long-term assets' are a particular type of investment and that disclosure should focus on how much capital investors have put into such assets. Please see our comments above (under 'definition of long-term investment') in relation to this. In our view, disclosure should focus on management of future risks rather than simply on past allocations.

In addition, this principle should explicitly state that beneficiaries have the right to access on request more detailed underlying information about where their money goes, rather than simply a breakdown by asset class. This would be in line with European law, which states that pension savers who bear investment risk must receive "detailed and substantial information on … the actual investment portfolio."[8]

As discussed above in relation to stewardship, in our view the principles should also explicitly require, or at the very least encourage, disclosure of information about voting and engagement by institutional investors.

[7] http://www.oecd.org/daf/fin/private-pensions/34018295.pdf
[8] IORP Directive, Article 11(4)