Fiduciary Duties of European Institutional Investors

Legal Analysis and Policy Recommendations[1]

Andrew Johnston[2] and Paige Morrow[3]

April 2016

Executive summary

Pension funds play a linchpin role in Western, capitalist economies by allowing citizens to save for their future, and are generally viewed as fundamental to the stability and long-term orientation of the production system as a whole.[4] It is essential to ensure that there is clarity as to society's expectations of them. In theory, they have the correct incentives to engage with investee companies to steer them towards the long-term. Yet evidence suggests this is not happening despite escalating soft law interventions.

Environmental, social and governance (ESG) risks are increasingly seen as financially material, both in positive terms (high ESG performance is correlated with improved long-term financial performance)[5] and in negative or defensive terms (ignoring them can result in lower returns or losses, directly through stranded assets, and indirectly through the vulnerability of investee companies to regulatory investigations, litigation, regulatory changes and reputational/brand damage).

Although trustees across the EU are legally permitted to take account of ESG factors in making investment decisions, the law in this area is vague and ill-defined. Furthermore, it appears that many investors are reluctant to factor these risks into their analysis, preferring instead to take a short-term, purely quantitative approach to management of risks across their portfolio.

The current state of the law on fiduciary duties is uncertain and it is unlikely that the courts will have adequate opportunities in the near future to clarify matters. It would therefore be extremely helpful to have clarification at the EU (and national) level about the extent of the discretion available to pension fund trustees. Many investors want to take account of ESG risks in their policies and decision-making but are currently being held back by legal uncertainties and (ill-founded) fear of liability. Guidance from the Commission would embolden pension funds to play the role that is expected of them by their beneficiaries and society.

The content of fiduciary duties

Pension fund trustees, as well as trustees of other trust-based investment funds, owe fiduciary duties to their beneficiaries. These duties are imposed on trustees through a combination of judge-made and statutory rules[6] on the basis that beneficiaries are dependent upon the exercise of their discretionary powers. This includes the power to select appropriate investments directly and to appoint a range of intermediaries, including investment managers and consultants to provide advice on asset allocation and carry out transactions.

A fiduciary owes a duty to act prudently (that is, conduct their affairs with '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)[7]. This procedural duty requires trustees to take expert advice where necessary, to monitor those to whom investment decisions have been delegated, and to diversify their portfolio. In the UK, this has been interpreted so that trustees are 'judged by the standards of current portfolio theory, which emphasises the risk level of the entire portfolio rather than the risk attaching to each investment taken in isolation.'[8] Fiduciaries also owe a duty of loyalty which requires them to act in good faith in the best interests

of their beneficiaries, avoid conflicts of interest, not to profit from their position, exercise powers for proper purposes and not to fetter their discretion.

There is a lack of case law in the UK and elsewhere on fiduciary duties in the investment chain[9], and indeed on the precise scope of the duties of pension fund trustees where they deal with complex investments.[10] This leads to legal uncertainty, and guided by conservative legal advice, trustees have tended to interpret 'best interests' of beneficiaries as referring to their narrow, short-term financial interests.

We show below that this narrow interpretation may not be required by law, and that trustees have a wider discretion to take account of environmental, social and governance (ESG) risks than is commonly appreciated.

Fiduciary duties of trustees and ESG risks

The UK case of *Cowan v Scargill*[11] is widely viewed as the leading authority on the extent to which pension fund trustees may take account of these wider factors in setting out investment policies and making investment decisions. In that case, representatives of a mining trade union put in place a policy which required divestments of overseas investments and land interests, as well as a freeze on investments in 'energies which are in direct competition with coal'. The court held that the policy amounted to a breach of fiduciary duty because it was not in the beneficiaries' best interests: the connection between the success of the coal mining industry and the beneficiaries (many of whom were retirees, widows and children with no further financial interest in the coal industry) was 'too speculative and remote'. In other words, the beneficiaries' interests could not be equated with those of the union and the industry as a whole, and these decisions therefore reflected the trustees' political preferences.

A 2005 report commissioned by the UNEP Finance Initiative (commonly referred to as the Freshfields Report)[12] concluded that the Cowan decision has been 'misunderstood' and that this has 'coloured' the position in the UK.[13] They conclude that the case 'turned on its own facts' so 'cannot be relied upon to support the single-minded pursuit of profit maximisation, or indeed any general rule governing investment decision-making'.[14] There is also legal authority to the effect that negative screening (that is, excluding whole categories of investment) is not a breach of fiduciary duty 'so long as the trustees are satisfied that course would not involve a risk of significant financial detriment'.[15]

The Freshfields Report further concluded that trustees must take account of ESG factors where those factors are 'reasonably expected to have material impact on the financial performance of the investment', and *may* take account of ESG factors when choosing between equally attractive alternatives. Trustees in this situation should then follow prudent processes in order to weigh the ESG factors and so discharge their fiduciary duty of acting in good faith in the best interests of their beneficiaries. This will entail, at a minimum, taking proper advice, delegating appropriately, monitoring delegates and investments and diversifying in order to manage risk.[16]

However, pension fund trustees often seek to demonstrate that they have discharged their duty of prudence by 'benchmarking' asset managers against their peer group, which can lead to herding into particular types of investments (increasing rather than decreasing risk) and an unwillingness to consider new strategies[17] (such as taking account of ESG risks).

More recently, a report produced by the UN Principles for Responsible Investment (UN PRI) stated that '[f]ailing to consider long-term investment value drivers, which include environmental, social and governance issues, in investment practice is a failure of fiduciary duty.'[18]

The UN PRI Report recommended that '(t)he European Commission should provide guidance to the competent member state authorities on how they should interpret fiduciary duty in the national legal context.' **This guidance should:**

- Clarify that fiduciary duty requires asset owners to pay attention to long-term factors (including ESG factors) in their decision-making and in the decision-making of their agents.
- Clarify that responsible investment includes ESG integration, engagement, voting and transparent public policy engagement.
- Encourage member states to ensure that fiduciary duty and responsible investment-related legislation is harmonised and consistent across Europe.
- Encourage member states to monitor the implementation of legislation and other policy measures relating to fiduciary duty and responsible investment, and report on the investment and other outcomes.

Barriers to consideration of ESG risks by trustees

Understandings of the relevance of ESG risks to financial returns are constantly changing, and are affected by 'changes in legislation and policy, by changes in risk and the understanding of risk, by changes in the social, environmental and economic impacts of the ESG issue in question, and by changes in societal (and beneficiary) expectations and norms.'[19] However, the current institutional structure of the market for investment services makes it difficult for these changing understandings to influence practice.

First, it is important to note that most pension fund trustees do not make investment decisions themselves. They delegate this power to asset managers, who probably owe fiduciary duties to the pension trustees,[20] and may, in some cases, even owe them to the end beneficiaries.[21] Where investment powers are delegated, the trustees continue to owe fiduciary duties to the beneficiaries.

Even if pension fund trustees hold strong views that ESG risks should be taken into account, there are significant barriers to asset managers and investment consultants doing this. As both the Myners Report of 2001[22] and the Kay Review of 2012[23] identified, the performance of asset managers tends to be assessed on a very short-term basis and in comparison with their peers. It is also clear that most pension fund trustees do not include specific ESG instructions in their mandates to asset managers.

The result is a lack of alignment between the incentives and decision-making of asset managers and the financial interests of end beneficiaries. Pension fund trustees who fail to give mandates to asset managers which require them to adequately protect the best interests of beneficiaries may be in breach of the fiduciary duties of prudence and loyalty. However, there is a lack of clarity surrounding duties and required standards in this area of the law because litigation by beneficiaries against trustees or by trustees against asset managers is practically non-existent. As a result, the law does not provide clear signals to these important intermediaries.

Second, there are significant difficulties in quantifying ESG risks, and these become more pronounced as the risks become more systemic (e.g. climate change risk as opposed to specific environmental risks).[24] This makes it hard to integrate these risks into existing financial risk management processes, which tend to focus on quantified risk at a portfolio or asset class level.

Third, there are problems with information disclosure. Many of the investment vehicles in which pension funds increasingly invest (such as hedge funds and private equity) are under no obligation to disclose the ESG risks associated with their investments, or even their ESG policies.[25]

The UN PRI encourages investors committed to socially responsible investment (SRI) to press such funds to make these disclosures. However, at present, this is not happening in significant numbers, and so represents another misalignment between the short-term incentives of financial actors and the long-term interests of pension fund beneficiaries.

Fourth, trustees may fear personal liability if they take account of ESG risks even though courts rarely review pension trustees' decision-making and, in those rare cases where it does occur, the courts are reluctant to second guess decisions.[26] Moreover, it is very unlikely that trustees would face personal liability for considering, or for failing to consider, material ESG risks.[27] These fears indicate extreme risk aversion, and it is often suggested that they derive from conservative legal advice given to pension fund trustees.[28]

Finally, many investors rely on passive investment strategies that track market indices and fail to include ESG considerations. While indices are being developed to help investors adopting a passive strategy to take account of ESG issues, these investors at present do not review the ESG performance of the underlying securities in which they are interested through the index.[29]

Environmental risk and opportunity: climate change

There is increasing evidence that taking account of ESG issues should no longer be viewed simply as an ethical matter. ESG issues present financially material risks and opportunities that must be identified, managed and disclosed.[30] Individual events may have a significant negative impact on a firm's earnings and market capitalisation, as demonstrated by Volkswagen's 2015 emissions scandal, which caused the loss of 23% of the company's market capitalization, which means 15.6€ billion, in only one day[31] and potential recall costs related to 482,000 vehicles, with up to 11 million vehicles affected,[32] in addition to the costs associated with various legal claims brought against the company and the

reputational damage it suffered. More generally, financial risk from environmental factors may arise where individual investments are jeopardized by the effects of pollution, extreme weather events (e.g. heat waves, droughts, flooding), or most broadly from climate change.[33]

Many institutional investors have publicly acknowledged that current economic models of the impact of climate change have inadequately considered the significant tail risks associated with extreme climate change and thus underestimate the associated economic risks.[34] Other institutions have also made public statements about the materiality of climate change, including Mark Carney, Governor of the Bank of England.[35]

Environmental risks can impact on the interests of beneficiaries in two main ways.

First, they can impact on the value of specific investments. Examples include fossil fuel energy companies whose assets may become stranded; concession and construction companies in charge of maintaining core infrastructure with very long-term contracts; and tourism infrastructure such as ski resorts. Those risks may come from the environment itself,[36] from litigation,[37] or from regulatory responses to changes in the environment.[38] In their stewardship role, large pension fund trustees holding shares in these entities could press the directors to insure against these risks, which would quantify the risk and impact on the value of shares, potentially creating pressure for a change of business model where the risk is elevated.

Second, they can contribute to the ongoing destruction of the environment as an essential system on which the beneficiaries depend for their quality of life, and even their survival. Thus the G20/OECD High-Level Principles on Long-term Investment Financing highlight the need for the governing bodies of institutional investors to measure, monitor and manage the long-term environmental (as well as social and governance) risks in their portfolios.[39] Yet this second category is harder to reconcile with fiduciary duty, and particularly the requirement that the connection between investment decisions and beneficiary returns not be 'too speculative and remote'. As the *Cowan* case noted, even the largest pension fund cannot hope to save a national economy by its actions alone. This logic applies with even more force to the environmental system. As 'universal owners',[40] pension funds arguably have an interest in the survival of the planetary ecosystem, both because it affects the returns on their investments and because it affects what their beneficiaries will be able to do with those returns in the future. This implies that pension funds should act collectively, by putting pressure on policy makers to address these problems, and to coordinate investment strategies in relation to particular sectors. However, as things stand, this is a minority pursuit, confined to pension funds which have committed themselves to be socially responsible investors.[41]

At the same time, ESG integration can have a positive impact on portfolios and there is evidence that companies with better ESG ratings tend to have better long-term financial performance (measured over 15-20 years),[42] improved credit ratings,[43] and a lower cost of borrowing.[44]

Indeed, a study of 1,500 firms from 26 developed countries over a 77 month period concluded that (1) there were no indications that the integration of aggregated or disaggregated corporate environmental responsibility ratings into pension fund investment processes had any detrimental financial effect; and (2) considering ESG resulted in substantially lower downside volatility.[45] Thus, ESG integration may be considered financially material both in terms of risk and opportunity.[46]

Social risk and opportunity: human rights

The discussion of social risk is perhaps less advanced than environmental risk, but there is increasing recognition of the role that institutional investors play in contributing to or mitigating the human rights impact of (transnational) business. Furthermore human rights may become financially material when they give rise to reputational or brand damage, lawsuits or regulatory investigations.[47] The Report of the Special Representative of the UN Secretary-General on the issue of human rights and transnational corporations and other business enterprises noted that, in most jurisdictions, pension fund trustees "need to consider the impact on human rights of an investment if not doing so could expose the fund to legal or reputational risk."[48]

The argument that institutional investors have an obligation to monitor and respond to human rights is now new. For example, during apartheid in South Africa, UK institutional investors were active players in the transition due to their divestment from the worst offending companies and their adherence to a Code of Practice/Code of Conduct governing their role in South Africa, as were other EEC Member States[49]

More recently, it has been confirmed that the OECD's Guidelines for Multinational Enterprises[50] apply to fund managers and minority shareholders. The OECD's complaint resolution mechanism has explored the extent to which institutional investors as minority shareholders have a responsibility to pressure investee companies to improve their human rights performance, or to divest. In a complaint brought against the South Korean company POSCO and two of its investors, the Dutch pension fund ABP and its pension administrator APG,[51] the Dutch National Contact Point confirmed that the OECD Guidelines apply to financial institutions that have minority shares in multinational enterprises. Although ABP and / APG held less than 1% stake in POSCO, they had an obligation to prevent or mitigate any violations carried out by the investee company.

Similarly, the Office of the High Commissioner for Human Rights (OHCHR) is of the view that the UN Guiding Principles on Business and Human Rights apply to institutional investors, even where they have minority shareholdings[52]

On the issue of minority shareholdings, there continues to be a need for practical guidance on the difficult questions of how due diligence can be carried out by investors adopting a passive or indexing strategy, and on what companies and investors are expected to do if they become aware of an adverse impact caused or contributed by an entity in which it invests through an index fund.[53]

Governance risk and opportunity: corruption

Perhaps the element of ESG with the most widely accepted link with financial performance is governance. For example, a recent study by Barclays indicated that a high ESG rating is a source of modest incremental return in corporate bond portfolios, with governance making the largest contribution to increased financial performance from 2007 to 2015.[54]

This aligns with existing research suggesting that 'good governance' is positively correlated with firm performance[55] by reducing the cost of capital, increasing industry-wide performance standards and increasing investment inflows.[56] Governance includes both sound internal management of the company (e.g. strong financial controls, appropriate executive remuneration, accounting and transparency) and external business ethics (e.g. compliance standards and combating bribery, corruption, money laundering and other malpractice). Issues of governance are already addressed to varying degrees in many countries through listing rules and soft law. However, institutional investors should ensure that they are satisfied with the governance arrangements of each of the companies in which they invest.

With respect to the specific example of corruption, the evidence regarding its correlation with financial performance is mixed but it appears that corruption undermines financial performance.

On the one hand, a refusal to pay bribes may involve costs if a company misses out on business opportunities. Indeed, some research has suggested enterprises with weak anti-corruption systems tend to increase their sales much faster in countries where corruption is prevalent compared to enterprises with strong anti-corruption systems. Conversely, the sales growth of both groups is similar in countries where corruption is less common.[57]

On the other hand, there is significant financial cost associated with legal actions and regulatory fines. For example, German engineering and electronics multinational Siemens AG agreed in 2008 to a record USD $800 million settlement of a detailed investigation under the US Foreign Corrupt Practices Act (FCPA).[58] The allegations by the Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) involved at least 4,200 payments totalling approximately $1.4 billion over six years to foreign officials in numerous countries. Additionally, regulatory claims can take a particularly long time to resolve, with an average of five to seven years.[59] A number of studies have shown that corruption negatively impacts on economic activity by reducing the average growth rate of both individual firms and entire countries.[60]

In jurisdictions where companies face liability for acts of bribery by their employees and agents, there is an incentive to develop and implement due diligence programmes to prevent and identify bribery within their business operations. For example, both the FCPA and the UK Bribery Act,[61] which create the prospect of criminal sanctions, provide for due diligence programmes as either a defence or mitigating factor.[62]

Taken together, the evidence suggests that a strong company-level anti-corruption programme can correlate with improved financial returns and this correlation may strengthen over time due to increased regulatory action against corporate corruption.[63]

Recent EU Developments

DG Environment study on fiduciary duties

The European Commission recently published a study of the duties of pension fund trustees and other institutional investors to consider ESG matters.[64] The study concluded that pension trustees are always allowed to take account of ESG factors where they consider them pertinent to the best interests of members (although they are not required to do so, except in certain special situations).

Among its key recommendations for action were:

- National financial authorities with support from the European Commission should provide official guidance and interpretation of fiduciary duties and the extent to which institutional investors may or must include ESG issues in their investment strategies and decisions.
- This should take the form of a reference document which makes clear that taking account of ESG risks is compatible with, and even required by, fiduciary duty.
- Mandatory disclosure of responsible investment policies by all institutional investors, and a mandatory clear statement if they do not have such a policy in place (i.e. 'comply or explain' basis).
- Institutional investors should be monitored to ensure that they have sustainable and responsible investment policies.
- Institutional investors should be encouraged to inform and consult with beneficiaries to determine their 'best interests', especially on environmental and social issues.
- Institutional investors should be required to measure the environmental and social impacts of their investments.

Shareholder Rights Directive Revision

The current revision of the Shareholder Rights Directive proposes to require institutional investors to adopt and disclose an engagement policy, which includes monitoring investee companies to reduce environmental and social risks, and to disclose its implementation and results.[65]

The requirement would apply on a comply or explain basis, with investors that choose not to have such a policy, or choose not to disclose its implementation and effects, being required to give a 'clear and reasoned explanation'.[66] As of February 2016, the revised directive is in trilogue negotiations between the Commission, Council and Parliament. The proposal of adopting engagement policies is also endorsed by Ernst and Young in its report for DG Environment on the fiduciary duties of investors.

IORPS Revision

In the ongoing revision of the Institutions for Occupational Retirement Provision Directive (IORPs)[67] there has been considerable debate about the inclusion of ESG considerations. The Commission initially proposed that trustees' 'risk evaluation should include new or emerging risks, such as risks related to climate change, resource use or the environment' (article 29).[68] Civil society organisations led by UK-based ShareAction and responsible investors such as Eurosif have pushed for the reintroduction of this provision and further amendments to clarify that investing in members' best interests and the Prudent Person Principle are compatible with considering ESG issues and the long-term consequences of investment decisions.[69]

Recent Global Developments

There is increasing recognition worldwide of the critical role institutional investors play in promoting responsible, long-term investment. For example, the G20 under the Chinese Presidency has asked the OECD to explore the fiduciary duties of institutional investors, with a focus on climate-related issues.[70]

In the US, the Labor Department, which is responsible for the interpretation of the fiduciary duties of private industry pension plans,[71] issued guidance in late 2015 advising that pension fund fiduciaries can consider ESG matters in their investment decisions.[72] US fiduciaries cannot accept lower expected returns or greater risks, but may take ESG into account as 'tiebreakers' when investments are otherwise equal.

When ESG matters have a direct relationship to the economic and financial value of an investment "these factors are more than just tiebreakers" and therefore must be considered. The guidance was a response to demands from fiduciaries, civil society and unions that sought "clearer legal or regulatory support for fiduciaries to engage in SRI."[73]

Policy Recommendations

National financial authorities with support from the European Commission should provide official guidance and interpretation of fiduciary duties and the extent to which institutional investors may or must include ESG issues into their investment strategies and decisions both in terms of risk and opportunity. The Commission has issued similar guidance through influential albeit not legally binding recommendations, for example on the quality of corporate governance reporting.[74] The guidance would clarify minimum expectations across the EU and settle the question of ESG issues and fiduciary duties.

The Commission might also point out that the duties of asset owners require that they ensure that mandates given to asset managers:

- reflect the asset owners' views on the relevance of ESG risks to beneficiaries' returns; and
- are sufficiently long-term, and include performance measures and incentives which are aligned with the interests of beneficiaries.

The Commission could issue guidance in the form of model mandates or through the promulgation of a code of best practice for trustees and investors.[75] Additional thought should also be given to how hard or soft law might be used to extend the time horizons in which asset manager performance is assessed to bring it into line with beneficiaries' financial interests.

In the longer-term, it will be necessary to look at readjusting asset managers' mandates/benchmarks to integrate ESG criteria and thereby refine incentives to encompass extra-financial matters. Although it is unlikely that asset managers' performance will be assessed over periods significantly exceeding one year, claw-back clauses could be used to cover the possibility of materialised environmental or social harm. Claw-back clauses are already used for bankers' bonuses to deter excessive risk-taking and improper conduct.[76] Another option would be to change benchmarks so that asset managers would be compared only to SRI funds or other relevant peer groups, rather than to traditional funds investing in the same asset classes.

The central message should be that investors do not have a duty to maximise short-term returns and that fiduciaries already have scope in law to consider ESG matters and even systemic environmental risk because these are salient to long-term pension fund performance. A stronger action would be to explicitly require institutional investors to consider ESG risk and then impose a corresponding requirement on hedge funds, private equity and other financial vehicles to disclose ESG risk information (of which they are aware or ought reasonably to be aware) to their investors.

References

1. This paper benefited from comments by Luke Blindell, Sandrine Brachotte, Mike Clark, Camilla de Ste Croix, Frédéric Hache and Hamish Stewart. Further comments may be directed to paige.morrow@frankbold.org.
2. Professor of Company Law and Corporate Governance, School of Law, University of Sheffield and a member of the Sustainable Market Actors for Responsible Trade (SMART) Project (http://www.jus.uio.no/ifp/english/research/projects/smart/), which is based at the University of Oslo. The SMART Project is funded by the EU HORIZON 2020 framework programme, and we gratefully acknolwedge its support.
3. Head of Brussels Operations, Frank Bold; Visiting Law Lecturer, Brussels School of International Studies (BSIS), University of Kent.
4. Some commentators suggest that routine investment practices may undermine this role. See Blake, D., Sarno, L. and Zinna, G. (2015). The market for lemmings: Is the investment behaviour of pension funds stabilising or destabilising?. (Discussion Paper PI-1408). Retrieved from the Pension Institute website http://www.pensions-institute.org/workingpapers/wp1408.pdf.
5. See e.g. Eccles, R. G., Ioannou, I. and Serafeim, G. (2014). The impact of corporate sustainability on organizational processes and performance. Management Science 60 (11), 2835-2857; Tonello, M. and Singer, T. (2015) The Business Case for Corporate Investment in ESG Practices. (Director Notes No. DN-V7N4). Retrieved from the Conference Board website https://www.conference-board.org/retrievefile.cfm?filename=TCB-DNV7N4-Corporate-Investments-Practices1.pdf&type=subsite (mapping exercise of existing research on the link between corporate investment in ESG and financial performance at 9).
6. In the UK see for example *Pensions Act 1995* (c. 26), ss. 33-6 (UK).
7. *Re Whiteley* (1886) 33 Ch D 347 (UK), at 355 (per Lindley LJ.)
8. *Nestle v National Westminster Bank PLC*, (1996) 10 TLI 112) (UK) per Hoffmann J (the date of the judgment was 29th June 1988).
9. Law Commission, *Fiduciary Duties of Investment Intermediaries* (Law Com No 350, 2014), paras.10.22-10.40.
10. In particular, increasing use of derivative products to hedge risk, more investments in vehicles such as hedge funds and private equity, and greater holdings of foreign equities means that the capacity of fiduciaries to understand the products they invest in, the associated risks and the fee structures is stretched. There is no case law (as yet) on the liability of trustees for losses resulting from these investments. The Law Commission simply stated (at 7.76) that 'pension funds should only use derivatives if trustees fully understand the implications'. The effect of growing financial complexity is further reliance on advisors to allow trustees to show that they have acted with due diligence.
11. *Cowan v Scargill* (1985) Ch 270 (UK).
12. Freshfields Bruckhaus Deringer (2015). *A legal framework for the integration of environmental, social and governance issues into institutional investment*. Geneva: United Nations Environment Programme Finance Initiative (UNEP FI). Retrieved from http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf.
13. Freshfields Report, *op. cit.*, at 8.
14. See Freshfields Report, *op. cit.*, at 89.
15. In the case of *Harries v Church Commissioners for England* [1992] 1 W.L.R. 1241 (UK), Sir Donald Harries VC did not impugn (or cast any doubt on) the fund's pre-existing ethical investment policy which involved screening out around 13% of UK listed companies by market capitalization (which were involved in arms, alcohol, tobacco, gambling and newspaper publishing). Indeed, he said that he could find 'nothing in this statement of policy which is inconsistent with the general principles' of fiduciary duty and trust law.
16. Diversification alone is no longer an adequate risk management strategy. See Martellini, L. (October 24, 2010) A better approach to risk management. Retrieved from http://www.ft.com/intl/cms/s/0/53603d2c-de00-11df-88cc-00144feabdc0.html#axzz46HynT8g0: "One last misconception about risk management is that it is too often equated with risk diversification. Mistaking risk management for risk diversification again proved lethal in 2008, when sharp downturns in almost all asset classes painfully highlighted the limits of diversification as a risk management technique."
17. See Galer, R. (2002). "Prudent Person Rule" Standard for the Investment of pension funds assets. *Financial Market Trends*, 83, 41-75, at 59-60.
18. Sullivan, R., Martindale, W., Feller, E. and Bordon, A. (2015). Fiduciary Duty in the 21st Century. Geneva: UN PRI. Retrieved from http://www.unpri.org/press/new-report-aims-to-end-debate-about-esg-and-fiduciary-duty/, at 9.

19. *Ibid.*, at 19.
20. The UK's Law Commission recognised that 'there is no authority directly on point', but referred to two UK cases in which courts assumed that asset managers with discretionary powers would owe fiduciary duties to their clients and a Canadian case which stated that this situation would 'frequently' give rise to fiduciary duties (Law Commission, *Fiduciary Duties of Investment Intermediaries* (Law Com No 350, 2014), paras.10.22-10.23).
21. *Ibid.*, paras. 10.27-10.28.
22. Myners, P. (2001). *Institutional Investment in the United Kingdom*: A Review. London: UK Sustainable Investment and Finance Association. Retrieved from http://uksif.org/wp-content/uploads/2012/12/MYNERS-P.-2001.-Institutional-Investment-in-the-United-Kingdom-A-Review.pdf.
23. Kay, J. (2012). *The Kay Review of UK Equity Markets and Long-term Decision Making. Final Report*. London: UK Government. Retrieved from https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf.
24. See European Systemic Risk Board (ESRB) (2016). Too late, too sudden: Transition to a low-carbon economy and systemic risk (Report of the Advisory Scientific Committee No. 6/February 2016). Retrieved from the ESRB website https://www.esrb.europa.eu/pub/asc/html/index.en.html.
25. Indeed, pension fund clients have had trouble obtaining information as basic as fee structures. See Blake, D. (2014). On the Disclosure of the Costs of Investment Management (Discussion Paper PI-1407). Retrieved from the Pension Institute website http://www.pensions-institute.org/workingpapers/wp1407.pdf.
26. A beneficiary seeking to challenge a policy or decision would have to show that it is so unreasonable as to amount to a lack of good faith; pension fund trustees who can show that their policies and decisions are based on 'credible assumptions and robust processes' (*Fiduciary Duty in the 21st Century, op. cit.*, at 9) should have no fear of liability.
27. In rare cases where they are found to be in breach of fiduciary duty, whether as a result of a flawed investment policy, as in Cowan, or for failure to consider ESG risks, trustees may find themselves replaced, but are unlikely to face personal liability, as beneficiaries will find it impossible to show that the flawed decision-making caused them loss (that is, that a different policy or decision would have resulted in better returns).
28. See e.g. the Kay Review, *op. cit.*, para 9.20; Fiduciary Duty in the 21st Century, *op. cit.*, at 18.
29. See e.g. De Barochez, A. and Cozic, A. (2014). *Reconciling Responsible Investment with Passive Management*. Paris: Novethic. Retrieved from http://www.novethic.fr/fileadmin/user_upload/tx_ausynovethicetudes/pdf_complets/2014_passive_management_report.pdf.
30. Caldecott, B., Kruitwagen, L., Dericks, G., Tulloch, D.J., Kok, I., and Mitchell, J. (2016) *Stranded Assets and Thermal Coal. An analysis of environment-related risk exposure*. Oxford : University of Oxford, Smith School of Enterprise and Environment. Retrieved from http://www.smithschool.ox.ac.uk/research-programmes/stranded-assets/satc.pdf#page=6&zoom=auto,-202,708. The top 100 coal-fired utilities, top 20 thermal coal miners, and top 30 coal-to-liquids companies have been comprehensively assessed for their exposure to environment-related risks, including: water stress, air pollution concerns, climate change policy, carbon capture and storage retrofitability, future heat stress, remediation liabilities, and competition from renewables and gas. The research is designed to help investors, civil society, and company management to analyse the environmental performance of coal companies and will inform specific investor actions related to risk management, screening, voting, engagement, and disinvestment. The research also has clear implications for current disclosure processes, including the new Task Force on Climate-related Financial Disclosures (see the official website: https://www.fsb-tcfd.org/). See also Moody's Incorporate ESG into Ratings (n.d.). Retrieved from http://www.ceres.org/investor-network/resolutions/moodys-incorporate-esg-into-ratings.
31. Kresge, N. and Weiss, R. (September 21, 2015). Volkswagen Drops 23% After Admitting Diesel Emissions Cheat. Retrieved from http://www.bloomberg.com/news/articles/2015-09-21/volkswagen-drops-15-after-admitting-u-s-diesel-emissions-cheat.
32. Volkswagen scandal underlines need for ESG analysis (n.d.). Retrieved from https://www.msci.com/volkswagen-scandal. The article goes on to question the use of traditional valuation models, such as discounted cash flow, which may fail to capture the range of ESG risks that companies face.
33. UBS (2014). *ESG Keys: Fossil Fuel Disinvestment: Is it the Answer? Distributed Disinvestment Is*. Geneva: Author. Retrieved from http://www.thegreenenterprise.com/wp-content/uploads/2013/11/UBS-Fossil-Fuel-Disinvestment-Is-it-the-answer-No-distributed-Power-Is-Sept30-2014.pdf.
34. Mackenzie, C. (April 2012). 'Unburnable carbon' Financial Advisor. Cited in Kaminker, Ch., and Stewart, F. (2012). The Role of Institutional Investors in Financing Clean Energy. *OECD Working Papers on Finance, Insurance and Private Pensions, No.23*. See also Organisation for Economic Cooperation and Development (OECD) (2012). *OECD Environmental Outlook to 2050. The Consequences of Inaction*. Paris: Author. Retrieved from https://www.oecd.org/env/indicators-modelling-outlooks/49846090.pdf, for information about the expected global economic slowdown.

35. See Clark, P. (29 September 2015). Mark Carney warns investors face 'huge' climate change losses. Retrieved from https://next.ft.com/content/622de3da-66e6-11e5-97d0-1456a776a4f5.
36. In the insurance context, insurers enter into arrangements to share risk (which is called 'reinsurance') and these reinsurers have models to determine the risk of catastrophic loss due to environmental disasters such as floods and windstorms, which suggests that environmental risk is financially material to insurers and their corporate policyholders. For more information about environmental insurance, see Kaminker, Ch., and Stewart, F., *op. cit.*
37. Columbia Law School's Sabin Center for Climate Change Law maintains a helpful register of climate change litigation (see http://blogs.law.columbia.edu/climatechange/).
38. See e.g. the US investigations of Peabody Energy and Exxon. NY Attorney General began investigating Exxon in November 2015 to determine whether statements the company made to investors about climate risks were consistent with the company's own long-running scientific research.
39. OECD (2013). *G20/OECD High-Level Principles on Long-Term Investment Financing by Institutional Investors*. Paris: Author. Retrieved from http://www.oecd.org/finance/private-pensions/G20-OECD-Principles-LTI-Financing.pdf.
40. Hawley, J., and Williams, A. (2007). *Universal owners: Challenges and opportunities. Corporate Governance: An International Review*, 15(3), 415-420.
41. The UN PRI plays an essential role in encouraging and guiding collective action by institutional investors on these issues.
42. Eccles, R. G., Ioannou, I. and Serafeim, G. (2014). The impact of corporate sustainability on organizational processes and performance, *op. cit.*
43. Portfolios with better ESG ratings show significantly less downside risk of more than 200 basis points even if they have a substantially lower number of constituents (Hoepner, A. G. F., Rezec, M. and Siegl, K. S. (2013). Does pension funds' fiduciary duty prohibit the integration of any ESG criteria in investment processes? A realistic prudent investment test (Working Paper in Responsible Banking and Finance No. 13-010). Retrieved from the University of St Andrews website http://www.st-andrews.ac.uk/business/rbf/workingpapers/RBF13_010.pdf).
44. Bauer, R., Hann, D. and Derwall, J. (2009). Employee Relations and Credit Risk. *SSRN Electronic Journal* 10/2009. Retrieved from https://www.researchgate.net/publication/228133715_Employee_Relations_and_Credit_Risk (Working Paper presented at the 2009 Academy of Management Meeting and at the 2009 Meeting of the American Accounting Association); Bauer, R. and Hann, D. (2013). Corporate Environmental Management and Credit Risk. *SSRN Electronic Journal*. Retrieved from http://ssrn.com/abstract=1660470; Oikonomou, I., Brooks, C. and Pavelin, S. (2011). The Effects of Corporate Social, Performance on the Cost of Corporate Debt and Credit Ratings'. Financial Review 49(1), 49-75.
45. Downside deviation measures the price volatility of a security by representing the potential loss arising from risk as measured against a minimum acceptable return, while isolating the negative portion of the volatility. (Hoepner, A. G. F., Rezec, M. and Siegl, K. S. (2013). Does pension funds' fiduciary duty prohibit the integration of any ESG criteria in investment processes?, *op. cit.*).
46. Another example of the direct relationship between environmental performance and stock price performance comes from research concluding that positive environmental news triggers positive stock price movements (Klassen, R. D., and McLaughlin, C. P. (1996). The Impact of Environmental Management on Firm Performance. *Management Science* 42(8), 1199-1214).
47. For example, Canadian gold mining company Nevsun Resources' gold mining operations in Eritrea have been the focus of UN reporting on modern slavery as well as civil lawsuits in Canada by alleged indentured labourers. A proposed acquisition of the company was delayed following the announcement of the slavery allegations. See e.g. United Nations, Human Rights Council *Report of the detailed findings of the commission of inquiry on human rights in Eritrea*, A/HRC/29/CRP.1 (5 June 2015) available from http://www.ohchr.org/EN/HRBodies/HRC/CoIEritrea/Pages/ReportCoIEritrea.aspx#report. For details of the civil complaint see Eritreans file lawsuit against Canadian mining company for slave labour and crimes against humanity (20 November 2014). Retrieved from http://www.ccij.ca/news/eritreans-file-lawsuit/ and http://www.biznews.com/briefs/2015/07/30/former-jse-star-lloyd-pengillys-qkr-scraps-expansion-plans-on-mining-rout/.
48. Ruggie, J. (2011). Report of the Special Representative of the Secretary-General on the issue of human rights and transnational corporations and other business enterprises. *Neth. Q. Hum. Rts.*, 29, 224.
49. The European Economic Community (EEC) was eventually supplanted by the European Union (EU). See Grand Britain, Department of Trade (1978). Code of Conduct for Companies with Interests in South Africa: Government Guidance to British Companies on the Code of Conduct Adopted by the Governments of the Nine Member States of European Community on 20 September 1977. *Cmnd 1-7233.*
50. See the official website: http://www.oecd.org/corporate/mne/.

51. See: Human rights breaches related to manufacturing of iron in India (n.d.) Retrieved from https://mneguidelines.oecd.org/database/instances/no0009.htm; Wachenfeld, M. (7 October 2013). Recent decisions clarify investor responsibility to address human rights concerns. How the OECD Guidelines for Multinational Enterprises relate to investors. Retrieved from https://www.responsible-investor.com/home/article/ncp_decision_analysis/.
52. United Nations, Office of the High Commissioner for Human Rights (OHCHR), *The issue of the applicability of the Guiding Principles on Business and Human Rights to minority shareholdings*, RRD/DECIB/CM/ff (26 April 2013) (letter from OHCHR to OECD Watch) available from http://www.ohchr.org/Documents/Issues/Business/LetterSOMO.pdf.
53. Gillard, T., Bijelic, B., and van Linder, E. (2014) *Scope and application of 'business relationships' in the financial sector under the OECD Guidelines for Multinational Enterprises.* Paris: OECD. Retrieved from https://mneguidelines.oecd.org/globalforumonresponsiblebusinessconduct/GFRBC-2014-financial-sector-document-2.pdf, at 5.
54. Donovan, P. (November 26, 2015). Nothing but a 'G' thang. Retrieved from http://ftalphaville.ft.com/2015/11/26/2145911/nothing-but-a-g-thang/.
55. Yermack, D. (1996) Higher market valuation of companies with a small board of directors. *Journal of Financial Economics*, 40, 185–211; Klein A. (1998) Firm performance and board committee structure. *Journal of Law and Economics*, 4, 275–304; Gompers, P., Ishii, J., and A. Metrick (2003) Corporate governance and equity prices. *Quarterly Journal of Economics*, 118, 107–156; Brown, L. D. and Caylor, M.L. (2006) Corporate governance and firm valuation. *Journal of Accounting and Public Policy*, 25, 409–434.
56. Agrawal, A. and Knoeber, C.R. (1996) Firm performance and mechanisms to control agency problems between managers and shareholders. *Journal of Financial Quantitative Analysis*, 31, 377–397; Himmelberg, C. P., Hubbard, R.G., and Love, I. (2001) *Investor protection, ownership and the cost of capital* (World Bank Policy Research Working Paper 2834). Retrieved from http://siteresources.worldbank.org/DEC/Resources/WPS2834.pdf; Daily, C. M., Dalton, D.R and Cannella, A.C. (2003) Corporate governance: Decades of dialogues and data. *Academy of Management Review*, 28, 371–382.
57. Healy, P., and Serafeim, G. (2011). Causes and Consequences of Firms' Anticorruption Efforts (Harvard Business School Working Paper). Retrieved from the Harvard Business School website: http://hbswk.hbs.edu/item/causes-and-consequences-of-firm-disclosures-of-anticorruption-efforts.
58. The FCPA permits firms to demonstrate that their compliance programmes were adequate as a 'mitigating' factor and permits prosecutors to take the firm's due diligence into account when assessing whether to lay charges or what types of penalties to apply in the event of a conviction.
59. AIG and European Confederation of Directors' Associations (ecoDa) (2015), *Guide to Directors' Duties and Liabilities.* Brussels: ecoDa. Retrieved from http://ecoda.org/uploads/media/ecoDa_Directors_Duties_Final.pdf, at 12.
60. Mauro, P. (1995) Corruption and growth. *Quarterly Journal of Economics*, 110, 681–712; Collins, J., Doh, J. P., Eden, L., Rodriguez, P., and Uhlenbruck, K., (2003) Coping with corruption in foreign markets. *Academy of Management Executive*, 17, 114–127; Eden, L., Hillman., A., Rodriguez, P., and Siegel, D.S. (2006) Three lenses on the multinational enterprise: Politics, corruption, and corporate social responsibility. *Journal of International Business Studies*, 37, 733–746; Doh, J. P., Eden, L., Rodriguez, P., and Uhlenbruck, K. (2006) The impacts of corruption on entry strategy: evidence from telecommunication projects in emerging economies. *Organization Science*, 17, 402–414. These studies are further supported by Donadelli, M., Fasan, M. and Sveva, Magnanelli, B. (2014). The agency problem, financial performance and corruption: Country, industry and firm level perspectives. *European Management Review* 11(3-4), 259-272, which confirmed these findings at the firm and industry levels.
61. *Bribery Act 2010* (c. 23) (UK).
62. While outside the scope of this paper, the due diligence model established by the UK Bribery Act is an interesting model for incentivising self-regulation. It may prove to be an attractive template for regulating other aspects of business behaviour where prosecutions are difficult, such as human rights risks in supply chains.
63. See e.g. Odom, C. (April 7, 2016). New DOJ program aims to beef up FCPA prosecutions. Retrieved from http://www.bna.com/new-doj-program-n57982069556/>.
64. DG Environment (2015) *Resource Efficiency and Fiduciary Duties of Investors. Final Report.* (ENV.F.1/ETU/2014/0002). London: Ernst & Young. Retrieved from http://ec.europa.eu/environment/enveco/resource_efficiency/pdf/FiduciaryDuties.pdf.
65. See article 3(f)(1) and (3) of the amendments adopted by the European Parliament on 8 July 2015 on the proposal for a directive of the European Parliament and of the Council amending Directive 2007/36/EC, as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU, as regards certain elements of the corporate governance statement (COM(2014)0213 – C7-0147/2014 – 2014/0121(COD)). For further discussion, see Johnston, A. and Morrow, P. (2014) *Commentary on the Shareholder Rights Directive* (University of Oslo Faculty of Law Research Paper No. 2014-41; Nordic & European Company Law Working Paper No. 15-13). Retrieved from the SSRN website: http://ssrn.com/abstract=2535274.

66. COM(2014)0213 – C7-0147/2014 – 2014/0121(COD), Article 3f(4).
67. 2014/0091 (COD).
68. This language was removed by the Council in their first compromise text and by the Parliament's Rapporteur in his draft text. However, amendments were passed by the Committee on Economic and Monetary Affairs (ECON) that reinstated the Commission's language and added some additional wording around ESG.
69. See the open letter of several associations addressed to Members of European Parliament 'Re: Improving transparency and management of environmental, social and governance risks in the révision to the Institutions for Occupational Retirement Provision Directive (IORPs)' dated 24 November 2015 (available at http://www.eurosif.org/wp-content/uploads/2015/11/IORPs-letter-to-MEPs.pdf).
70. Responsible Investor (February 16, 2016). G20 president China asks OECD to examine fiduciary duty responsibilities of institutional investors. Retrieved from https://www.responsible-investor.com/home/article/g20_oecd_fid_duty/.
71. These fiduciary duties apply to private pension plans subject to the Employment Retirement Income Security Act of 1974 (ERISA) (Pub. L. No. 93-406, 88 Stat. 829 (1974) (US)).
72. Employee Benefits Security Administration, Department of Labor, United States (2015) *Interpretive Bulletin 2015-01* (IB 2015-1). Washington D.C.: Department of Labor. The Labor Department noted that its earlier 2008 interpretative bulletin "unduly discouraged plan fiduciaries" from considering ESG risks. Their press release states that: "Changes in the financial markets since that time, particularly improved metrics and tools allowing for better analyses of investments, make this the right time to clarify our position." United States Department of Labor (22 October 2015). News Release: New guidance on economically targeted investments in retirement plans from US Labor Department. Retrieved from http://www.dol.gov/opa/media/press/ebsa/ebsa20152045.htm.
73. A survey conducted by the US Forum for Sustainable and Responsible Investment (USSIF) and Mercer in 2011 of public and other defined contribution pension plans found that 74% of 421 respondents felt that "clearer legal or regulatory support for fiduciaries to engage in SRI" was either "very important" or "important" (How Two Rulings Are Removing Roadblocks from Impact Investing (18 February 2016). Retrieved from the Wharton School, University of Pennsylvania, website: http://knowledge.wharton.upenn.edu/article/how-two-federal-rulings-are-removing-the-roadblocks-from-impact-investing/).
74. See European Commission, Recommendation of 9 April 2014 on the quality of corporate governance reporting, 2014/208/EU, which requires to 'comply or explain'. The Commission had earlier issued two additional recommendations: (1) The Recommendation of 14 December 2004 on the remuneration of directors of listed companies, which was revised by the Recommendation of 30 April 2009; and (2) The Recommendation of 15 February 2005 regarding the role of non-executive or supervisory directors and the committees of the (one-tier) board or the supervisory board. Both Recommendations have been subject to an Implementation Report (European Commission, Implementation Report from 2 June 2010, COM(2010) 285 final).
75. The Commission's Code could recommend contract terms and be on an advisory basis, at least initially. See Vayanos, D. and Woolley, P. (2016) Curse of the Benchmarks (London School of Economics Financial Markets Group Discussion Paper No. 747). Retrieved from the London School of Economics website <http://www.lse.ac.uk/fmg/workingPapers/discussionPapers/fmgdps/DP747CurseoftheBenchmarks.pdf> at 17.
76. See for example Prudential Regulation Authority (PRA). *PRA Rulebook*. London: Bank of England, PRA. Available on the official website: http://www.prarulebook.co.uk/. Para 15.21.

About us

The Purpose of the Corporation Project (an initiative of Frank Bold) provides a strategic, open source platform for leading experts and organisations interested in promoting the long-term health and sustainability of publicly listed companies through business management and public policy. The Project works with academics and practitioners to develop new options for corporate governance models. We also liaise with business, policymakers and civil society organisations to foster an open discussion with all stakeholders on the purpose of the corporation.

Frank Bold is a purpose-driven law firm using the power of business and non-profit to solve social and environmental problems.

www.purposeofcorporation.org
http://en.frankbold.org
@purposeofcorp