FIDUCIARY DUTY IN THE 21ST CENTURY


Note: the purpose of this document is to engage with, and seek feedback from, the key national stakeholders in the context of integrating environmental, social and governance (ESG) factors into fiduciary investors decision-making processes. This document is circulated for discussion purposes and is not intended for wider circulation.

BACKGROUND

In 2015, the Principles for Responsible Investment (PRI), the United Nations Environment Programme (UNEP) and the UN Global Compact published the report Fiduciary Duty in the 21st Century. The report concluded that fiduciary duty requires investors to consider long-term value drivers in the prudent practice of fiduciary investors. ESG factors are a core part of such an assessment and should be integrated into investment decision-making processes.

Fiduciary Duty in the 21st Century identified the principal barriers to ESG integration in the US. Lack of regulatory guidance, out-dated advice from service providers, lack of knowledge of ESG methods and weaknesses in corporate reporting were identified by industry stakeholders. The recommendations set out in this roadmap, individually and in aggregate, address these barriers and update our approach to the US market in light of progress in the US since Fiduciary Duty in the 21st Century was published in September 2015.

PROGRESS IN THE US - FOLLOWING FIDUCIARY DUTY IN 21ST CENTURY

The U.S. Department of Labor, which under ERISA has primary oversight of the administration of US private sector retirement plans, has recently issued a series of important rulings.

In Interpretive Bulletin 2015-01 released in October 2015, the Department of Labor clarified that ESG factors can be part of the “primary analysis” of prudent investment decision-making. Importantly, this rule rescinded previous guidance on the incorporation of ESG factors which had suggested that ESG investing should be “rare”.

Further, in another Labor Department rulemaking, the revised Fiduciary Rule, released by the Department in April 2015 and due to be finalized in the second quarter of 2016, significantly extends the range of investment intermediaries whose advice would be subject to a higher fiduciary standard (including, subject to exemptions, advice provided in relation to IRAs).
Finally, in Interpretive Bulletin 2015-02 released in November 2015, the Department of Labor proposed a series of initiatives to facilitate retirement provision at the state level – to expand access to retirement vehicles.

A central recommendation of Fiduciary Duty in the 21st Century was answered through Interpretive Bulletin 2015-01, by providing guidance that ESG factors can be part of the “primary analysis” of prudent investment decisions. Taken together, these initiatives also indicate that defined contribution products and state-based schemes are critical points of focus in the developing market for retirement provision.

SCOPE AND PURPOSE
Our roadmap identifies strategic leverage points in the US investment market for advancing the modern interpretation of fiduciary duty. Our work also engages with the broad trends in the US market for retirement and investment products – understanding the market today but also the market as it may look in ten to twenty years’ time.

PROPOSED RECOMMENDATIONS FOR THE US - FOR DISCUSSION WITH INDUSTRY STAKEHOLDERS

- Engagement and stewardship of investee companies – active ownership
  - Stewardship

Major institutional investors have begun to promote active engagement with their investee companies. ERISA guidance has previously stated that shareholder rights in investee companies are an asset of fiduciary investors to be utilised in the interests of beneficiaries.

Stewardship Codes have been adopted in developed markets, such as the UK and Japan, on a ‘comply or explain’ basis. Rates of adoption and reporting suggest that there is significant value to codifying value-relevant stewardship practices and holding industry actors to account against them.

**Recommendation:** US regulatory agencies, namely the SEC and the Department of Labor, should co-operate to develop a Stewardship Code, which integrates ESG factors into the terms of the code, establishes effective monitoring and enforcement and seeks to reflect best stewardship practices in the investment industry.

- Engagement

The Department of Labor has, as previously stated, asserted that shareholder rights are an asset of fiduciary investors. Funds with strong ESG approaches, such as CalPERS, generally publish proxy-voting intention. This is good practice on investment transparency. It encourages investors to explain their decisions and to consider carefully the best use of their proxy opportunities.
We note that one of the purposes of disclosure is to increase the prospects of a successful vote by enabling other actors to assess the identity and orientation of the relevant investors – without solicitation. Disclosure infrastructure is inexpensive and broadly available through investors’ own platforms and those of proxy advisory firms. We also note that we have seen a number of very active, contested proxy seasons in recent years.

**Recommendation:** The SEC should recommend disclosure of proxy-voting intention. The Department of Labor should consider reminding the investment industry of its fiduciary obligation to engage with investee companies in their beneficiaries’ best interests. In doing so, it should withdraw and re-issue its Interpretive Bulletin from October 2008 (29 CFR 2509.08-1) setting out language consistent with IB2015-01 as to the legitimate scope and considerations of investment practice of fiduciary investors. We note that the practice of disclosing proxy-voting intention could also be part of best investment practice highlighted in a stewardship code.

- **Integrate ESG factors into State Plan regulation and guidance**

  A significant proportion of retirement provision in the US is provided at the State level. We have noted that the Department of Labor has sought, through IB2015-02, to expand access to retirement products through a range of state plan options.

  State regulators, in common with federal guidance and rule-making, should ensure that all plan beneficiaries obtain fiduciary protection (whether in respect of advice or governance) and that investment decisions in relation to such assets account for ESG factors.

  **Recommendation:** The incorporation of ESG belief statements into all state plan investment policies. Updating policy guidance, such as the Government Financial Officers Association (GFOA) Sample Investment Policy, to integrate ESG factors into investment decision-making guidance for state plans.

- **Modernize advisor practice – lawyers and investment consultants**

  PRI released guidance in February 2016 by Morgan, Lewis and Bockius and Groom Law Group on fiduciary duty in the US reflecting IB2015-01. This is the start of a program to adapt the default legal guidance given to the investment community to reflect the findings of Fiduciary Duty in the 21st Century, which identifies out-dated and narrow legal interpretations of fiduciary duty as a significant barrier to ESG integration.

  Part of this can be achieved through changing the mainstream perception of the litigation analysis for ESG integration. Litigation risk has often been cited as a reason not to integrate ESG – with investors concerned about diminished returns or uncertainty around “non-financial” disclosures. ERISA class-action cases are part of the evidence-base shifting the litigation analysis toward the primary risk being in not integrating ESG.
On the same theme, we plan to engage with the investment consultant community to ensure that the default approach to advising asset owners incorporates ESG factors.

**Recommendation:** To engage with investment industry advisors and consultants to ensure that fiduciaries are advised that ESG factors are a core element of prudent investment practice; advisors offer training to their clients on ESG factors; advisors report on their own ESG practices and publicize evidence on the connection between good ESG practices and investment performance.

- **US investor-statement on fiduciary investment practice**

  US PRI-signatories have led practice on ESG integration into investment decision-making processes. US PRI-signatories (such as Blackrock) have been vocal about the centrality of ESG factors to prudent investment decisions.

  This engagement can be consolidated into a statement by leading investors on the content of fiduciary responsibility. This builds the mainstream evidence-base for ESG integration and helps overcome industry skepticism.

  Such a statement provides a practical within-industry lever to embed the approach to ESG integration set out in IB2015-01, namely that ESG factors can be part of the “primary analysis” of prudent investment decision-making. We would anticipate that the Department of Labor would consider supporting such a strategic effort to accelerate the practical market acceptance of its recent guidance.

  **Recommendation:** To develop a statement to be signed by US investors which provides that the consideration of ESG factors is a core element of fiduciary investment practice.

- **Enhanced corporate ESG disclosure – practical, credible, decision-relevant**

  - **SEC**

    Conventional accounting information and reporting requirements conform to a set of generally accepted standards. Such standardization enables the disclosure of comparable information against which performance can be benchmarked and modeled.

    Lack of standardization of the reporting of ESG factors creates inconsistent reporting practices, raises the cost of production of such information and limits its usefulness to investors. The lack of a common materiality standard and the audience to which ESG information is addressed creates further complication.

    The SEC, through 10-K filings, provides an existing corporate reporting architecture and a materiality standard familiar to the investment industry. The SASB’s developing set of materiality disclosure standards for ESG factors are designed to sit within this architecture – supplementing it with sector specific disclosures of ESG metrics.
The SEC provided Interpretative Guidance in 2010 that the existing 10-K architecture required disclosure of material risks related to climate change. Investor feedback and the convening of the FSB Task Force on Climate Change Disclosures indicate that reporting companies’ response to this guidance was inadequate – with low or boilerplate disclosures being the norm. Guidance has not been sufficient to create a perceived industry requirement to disclose against ESG factors.

There is significant demand for standardized ESG reporting standards and an improvement in the quality and comparability of ESG reporting generally. Given this, there is significant value to the investment community to the SEC working towards incorporating the SASB’s developing material ESG disclosures within its 10-K filing framework. This would represent a significant and practical extension of the value and relevance of the SEC’s reporting framework to the investment community.

**Recommendation:** The SEC should adopt SASB’s developing guidance on material ESG disclosures within its 10-K filing requirements for reporting companies. Interpretive Guidance on the material financial impacts of ESG issues could also be issued by the SEC in advance of such incorporation – supplementing the previous guidance issued regarding climate change disclosures.

- **The Stock Exchanges**

  The major US exchanges have significant influence on the global listing market through ownership of non-US exchanges and listing a significant percentage of global market capitalization. Exchanges perform a vital function as information conduits and standard-setters, influencing the disclosure practices and expectations of both corporations and investors.

  We note that both NYSE and NASDAQ are signatories to the UN Sustainable Stock Exchanges initiative, of which PRI is a co-organizer, and members of the World Federation of Exchanges’ Sustainability Working Group. Thirteen exchanges have introduced guidance for reporting on ESG indicators with several more committed to produce guidance this year. Guidance by exchanges can enhance the consistency and comparability of ESG information available to investors. It assists issuers to identify and reduce the costs of reporting on ESG indicators through identifying reporting boundaries and materiality. Mandatory ESG disclosure is being adopted in a wide range of jurisdictions, responding to social expectations and investor demand. Exchange issued guidance on voluntary reporting of ESG indicators provides reporting companies with time to prepare for mandatory disclosure requirements to be issued by national regulators, in this instance, the SEC. Investors in US listed companies require timely, credible and decision-relevant information in respect of the ESG performance and characteristics of their investee companies – exchange issued guidance can play an important role in this.
Recommendation: NASDAQ and NYSE should provide guidance to their listed companies and investors to assess and report on ESG indicators to assist market preparation for mandatory ESG disclosures.

- The evolving landscape of fiduciary duty in the US

The US market for retirement products is undergoing significant structural change. At the same time, governments are responding, at both the national and international level, to expanded social expectations regarding the behaviour of the investment community.

Our roadmap seeks to engage with these trends as we advance the case and methods for ESG integration as a core element in fiduciary investment practice.

WE WELCOME YOUR THOUGHTS ON THESE TRENDS AND OUR SUGGESTIONS TO ACCOMMODATE THEM.

(I) Structural changes in pension provision: DB to DC

DB schemes are a minority and shrinking proportion of the retirement product market in the US. The overall trend in US pension provision is one of risk transfer. Corporate DB schemes are converting to DC whenever their funding position allows and many public DB plans are adopting hybrid DB/DC structures while adjusting their contribution and benefit profiles. A person not currently covered by a pension product is highly likely to find that their pension provision is obtained through a DC or IRA arrangement, particularly for a private sector worker. Increasingly, the modal American retiree will receive their pension benefits outside the trust-structure that has characterized DB pension provision.

These broad market trends lead us to suggest the following for discussion:

- The new Fiduciary Rule issued by the Department of Labor will require that the advice of a broader category of investment intermediaries is subject to a higher fiduciary standard. We expect that such intermediaries should take account of ESG investment considerations as part of their fiduciary responsibilities when advising clients of their investment options.

- DC arrangements place the onus on beneficiaries to choose the manner in which their funds are invested. DC plans should include SRI investment options and should indicate whether ESG factors are incorporated into the management of all its options. As US-SIF and Mercer’s valuable report on DC trends indicated, critical to expanding such provision is establishing the performance of SRI products, their consistency with fiduciary duty and identifying a demand for SRI products from beneficiaries.

- With an expansion of pension options, corporate plans should provide education and advice to clients regarding ESG factors and SRI options.

(II) The voice of the beneficiary and enhanced public scrutiny
There is an expanding public consciousness of the social and environmental impacts of investment behaviour, particularly among younger future retirees and 'millennials'. Public scrutiny of the investment industry has increased with concern regarding its impact on society and the environment more generally.

The Paris climate talks focused on the role of business in responding to climate change. The EU have introduced enhanced disclosure requirements for large enterprises and several other jurisdictions, such as Japan and RSA, have mandated ESG disclosure from reporting companies.

Responding to these trends, we anticipate that beneficiaries will seek out methods to engage with their retirement providers on ESG factors. This will add, with increasing intensity, to the rising demand for ESG information and methods among asset owners.

This leads us to suggest that retirement product providers should develop methods for engaging their beneficiaries in their investment processes. They should also provide transparent and concise communication about the rationale for their investment decisions to their beneficiaries – including ESG factors as a core element.

(III) Systemic risks and fiduciary duty

Investors face a number of current and emerging systemic risks, climate change primary among them. Climate change may significantly alter the investment rationale for particular sectors, industries and geographies and may have large, generalized and negative impacts on economic output.

Accounting for material risks arising from ESG issues is, as we have indicated, consistent with fiduciary duties. We also note that fiduciary duty is an evolving concept, responsive to broad social and environmental expectations.

In this context, we suggest that systemic risks, particularly those arising from ESG issues, should be pro-actively identified and assessed as part of prudent investment decision-making. Given the increased likelihood of government and regulatory intervention with reference to climate change we suggest that investors adjust their practices and analytical capacities to identify, integrate and provide transparency on their management of such long-term systemic risks.

FIDUCIARY DUTY PROJECT - NEXT STEPS

The project team is reaching out to a range of industry stakeholders to engage on the proposed recommendations and trends set out above. Out of that engagement process a final set of recommendations for the US market will be developed and released this year. These will include a proposed set of implementation mechanisms to be actioned during the three years of our Fiduciary Duty project to advance ESG integration in the US investment market.