Executive Summary

In a world where millions depend heavily for their future wellbeing on a small number of people who look after their pension savings and other investments, the behaviour of those people matters deeply. This project set out to explore whether investors' fiduciary duties to the people whose money they manage are fit for purpose in the twenty-first century, particularly in light of the financial crisis. We conclude that the prevailing understanding of fiduciary obligation has lost its way, and that there is an urgent need to rediscover the essence of this valuable concept to ensure savers are properly protected by it.

Fiduciary obligation rediscovered

Fiduciary obligation is about ensuring that those entrusted to act on behalf of others do so reasonably and responsibly, and do not abuse their position for their own ends. But, in an investment context, this core protective purpose often seems to have been forgotten, replaced by the myth of a single, monolithic 'fiduciary duty to maximise returns'. In fact, investors have a number of distinct fiduciary *duties*, the two most fundamental being:

the duty of loyalty – fiduciaries must act in good faith in the interests of their beneficiaries, avoid conflicts of interest and not act for the benefit of themselves or a third party; this also includes a duty to act impartially between different classes of beneficiary;

the duty of prudence – fiduciaries must act with due care, skill and diligence, investing as an 'ordinary prudent man' would do; today this includes a duty to maintain an adequately diversified portfolio.

Prevailing interpretations of fiduciary duty have tended to subsume the duty of loyalty into the duty of prudence, leading to a neglect of the need to avoid conflicts of interest – particularly as regards the chain of investment agents who make key decisions on behalf of trustees. Moreover, the duty of prudence itself may not be serving the best interests of beneficiaries: the 'ordinary prudent man' standard is in danger of becoming a 'duty to herd', leading to an unhelpful focus on short-term, benchmark-relevant strategies and making the industry slow to adapt. In addition, just as fiduciary obligation evolved in the twentieth century to take account of modern portfolio theory, so it may need to evolve in the twenty-first to take account of wider factors affecting outcomes for beneficiaries, such as systemic and extra-financial risks.

The new fiduciaries

It is not just our understanding of *what* fiduciary obligation is that needs to change, but also our understanding of *who* is a fiduciary. Pension scheme trustees are acutely aware of their strict fiduciary duties – but what of the asset managers and investment consultants to whom they increasingly delegate crucial decisions? And what about the millions of people whose pension savings are based on a contract with an insurance company, a structure in which there are no trustees at all?

Asset managers frequently refer to themselves as fiduciaries, and it is our belief that this does reflect the underlying legal position. But this often seems to be simply a byword for a duty of care towards clients, which applies to all commercial actors, rather than a true appreciation of the much stricter standard of loyalty to which fiduciaries are held. Certainly, if the role of a fiduciary is to put the interests of their beneficiaries above their own, the sharply divergent fortunes of savers and their intermediaries seen in recent years should give cause to question whether fiduciary standards of care are really being achieved in practice.

Unlike asset managers, UK investment consultants do not generally appear to see themselves as fiduciaries – although they are accepted as such in the United States. Given the enormous influence consultants exercise over the decisions of many trustees, we believe that asset managers are indeed fiduciaries under the common law.

We suggest that the regulator should clarify the legal responsibilities of both asset managers and investment consultants towards clients and their beneficiaries. In particular, intermediaries should be reminded that fiduciary obligation includes a duty to avoid conflicts of interest, and, where this is not possible, to manage them effectively. If this is deemed to be impossible under current business models, there is a need to countenance the possibility that it is the business models and not the fiduciary duties which must be changed.

With the shift from trust-based to contract-based pension arrangements, an increasing volume of savings are passing out of the fiduciary sphere altogether. Little consideration has been given to the legal duties owed by insurance companies to their policyholders, or to the potential accountability gap that arises with the absence of trustees. The legal and regulatory framework applying to trust- and contract-based pension providers is uneven. There is an urgent need to review this situation to ensure that pension savers receive the same level of protection regardless of the form of their pension arrangements.

Incentivising responsibility

But it is not enough simply to extend the fiduciary label to a new set of actors and assume that this will protect their beneficiaries. As indicated above, our understanding of fiduciary obligation itself may need to evolve to keep pace with the new challenges facing fiduciary investors.

This is particularly true when it comes to responsible and sustainable investment approaches: historically, fiduciary obligation has more often been interpreted as a barrier to such approaches than a catalyst for them.

In recent years, this has begun to change, with increasing acceptance that serving beneficiaries' best interests requires the consideration of environmental, social and governance (ESG) issues with the potential to affect *financial* returns. But this acceptance is not yet fully reflected in mainstream investment practice. We conclude that one of the key barriers is an absence of incentives: there is a mismatch between the long-term benefits of better ESG risk management and the shorter-term performance benchmarks against which most asset managers are assessed.

Continued confusion over the nature of fiduciary duties may also be holding responsible investment back. Survey evidence suggests a tendency for actors at all stages of the investment chain to see ESG integration as 'somebody else's problem', with a lack of clarity over where the trustees' responsibilities end and those of their agents begin. This is perhaps connected to a lingering perception of ESG as a client-driven ethical preference rather than a truly integral part of financial analysis.

It is also notable that fiduciary obligation is invoked disproportionately to justify neglect of ESG issues, but neglect of ESG issues rarely gives rise to accusations of breach of fiduciary duties. After the Deepwater Horizon oil spill led BP to cancel its dividend for the first time since the Second World War, nobody suggested that trustees might be exposed for having failed to scrutinise the company's risk management. The growing momentum behind responsible investment in some parts of the industry presents an important opportunity for positive change in this area.

Beyond financial interests

The debate over responsible investment raises a further question: can fiduciaries act on environmental and social issues only when they are material to financial returns? Pension fund members who enquire about an ethical issue often encounter the seeming paradox of being told that their views must be ignored because of the trustees' fiduciary duty to act in their best interests. But are trustees legally restricted to interpreting this duty only in terms of financial best interests?

A close reading of case law – particularly the landmark case of Cowan v Scargill, which has cast a long shadow over the idea of 'ethical investment' – does not support the idea that non-financial interests are automatically off-limits for trustees. Indeed, the judge in Cowan v Scargill explicitly confirmed that non-financial benefits might, under some circumstances, be a legitimate consideration. In this context it is important to remember that fiduciary obligation is not about ensuring trustees make a 'correct' decision based solely on mathematical calculations of risk and return; rather, it is about ensuring their decision-making process is sound, reasonable and motivated by the beneficiaries' best interests.

We conclude that a prudent ethical investment policy, which does not compromise beneficiaries' financial interests and is firmly rooted in their own ethical views, ought to be possible both legally and in practice. But the legal position remains unclear, and statutory clarification may be needed to restore common sense to the law and resolve a debate that has generated more heat than light. We suggest that trustees should be given greater freedom to exercise their judgement, in good faith, on how to serve their beneficiaries' best interests.

Debate around non-financial interests has tended to fixate on ethical issues, neglecting the question of whether trustees can consider the impact of their decisions on beneficiaries' future quality of life – for example, through social and environmental factors such as climate change. If the purpose of a pension trust is to provide its members with pensions, then what is the purpose of the pension? The obvious answer is 'to provide a decent standard of living in retirement'. This raises the question whether, like charities, pension funds should be free to consider whether their actions are undermining this underlying purpose.

The key issue that arises here, both legally and practically, is the 'remoteness problem': individual investors may be too small to have a material impact on a given macroeconomic issue. This creates a serious collective action problem if – as with climate change – the optimal outcome for all beneficiaries would be universal action which *could* have a material impact on the problem. Further thought needs to be given to how this problem can be overcome, whether through investor collaboration, legal changes, or some combination of the two.

The member's contribution

Any discussion of what is in beneficiaries' 'best interests' inevitably raises the question of who decides what those best interests are. Historically, the fiduciary relationship has been assumed to be a more or less paternalistic one, where trustees are left to decide what will serve beneficiaries' interests with minimal regard for the views of beneficiaries themselves. But is this still appropriate?

We conclude that pensions are meaningfully different from private trusts in this respect, since the beneficiaries themselves provide the capital to be invested (either through their own contributions or indirectly through employer contributions, which are effectively deferred remuneration).

Moreover, with the shift towards defined contribution (DC) arrangements, they increasingly bear the investment risk. In this context, it is difficult to maintain the argument that they should have no say at all in how their money is managed. Research also suggests that people value communication and consultation, and that such engagement may help overcome the distrust that puts many off from saving into a pension at all. Yet members who contact their pension funds to enquire about an issue or express a view often encounter disinterest or even hostility.

Pension providers should be encouraged to consult and inform their members. This applies to both trust- and contract-based providers: insurance companies should consider ways to improve their outreach and ensure that the choices they offer reflect their policyholders' priorities. Some legal changes may be needed to facilitate this shift towards greater member involvement, both to clarify the extent to which members' views may be taken into account by trustees if it has not been possible to ascertain the views of *all* members, and to guarantee members an adequate level of disclosure and consultation.

The enlightened fiduciary

Finally, debates over the role of investors in the wake of the financial crisis suggest a need to look beyond beneficiaries. Collectively, pension funds are now important actors in the global economy, a far cry from the family trusts of the eighteenth century for whom fiduciary obligations first developed. The fiduciaries of today include giant institutions whose decisions have a very real impact on the economy, on society and on the environment. Does this impact justify granting rights to other stakeholders beyond the beneficiaries to whom fiduciary obligations are traditionally owed?

Ultimately, we conclude that this is not desirable. The duty of undivided loyalty is, as we have seen, at the heart of the fiduciary relationship. Undermining this would undermine the fundamental purpose of fiduciary obligation. However, there may be other ways of protecting the public interest and encouraging enlightened behaviour which do not interfere with the basic nature of the fiduciary relationship. Section 172 of the Companies Act 2006, which requires company directors to 'have regard' to the longer-term and wider consequences of their decisions, provides a useful model. This model preserves the primacy of fiduciaries' duty to their beneficiaries, but recognises that beneficiaries' long-term interests may often be best served by an enlightened approach.

Indeed, it is somewhat paradoxical that a similar provision has not been applied to institutional investors. The Companies Act provisions are based on the idea of 'enlightened shareholder value'. At present, there is a direct conflict between this model and the perception of many fiduciary investors – who are themselves the shareholders in question – that their legal obligations actively *prevent* them from taking an enlightened approach. This perhaps contributes to a situation where many directors report feeling under pressure from shareholders to maximise short-term returns even at the expense of long-term business growth. As policymakers seek to put the economy back on a stable and sustainable footing in the wake of the financial crisis, it is vital that they rectify this mismatch.

Conclusion

In light of all these issues, the time has come for a fundamental review of the fiduciary obligations of investors. Such a review has much to contribute to many of today's great policy challenges, from providing for an ageing society to achieving stable and sustainable economic growth. A rediscovery of basic fiduciary principles – in particular, the duty of loyalty to beneficiaries – would help refocus post-crisis debates about investment governance on the people whose money is at stake, and on the need to ensure that the financial system acts as their servant and not their master. But it is also time to move on from an outdated view of fiduciary obligation as a straitjacket which prevents investors from behaving in an enlightened and responsible manner. We hope that this report and its recommendations will act both as a useful contribution to this crucial debate, and as a catalyst for action.

Key findings of this report

- Prevailing interpretations of fiduciary obligation have lost their way, neglecting the core duty of loyalty – including the duty to avoid conflicts of interest – in favour of a narrow focus on maximising returns.
- The rise of 'agency capitalism' – whereby the gains of investment activity go disproportionately to intermediaries rather than underlying owners – is inconsistent with the fiduciary concept. There is an urgent need to consider how fiduciary standards can be achieved, not just by trustees, but by all those responsible for managing other people's money.
- The increasing acceptance that sustainability and other 'ESG' factors can affect returns presents an opportunity to tackle the perverse incentive structures and misunderstandings of fiduciary obligation which continue to hold back responsible investment in practice.
- There is also a need for legal clarification of the extent to which pension funds can take non-financial factors into account for their own sake, to resolve a decades-old debate on 'ethical investment' that has generated more heat than light.
- In a world where pension fund members both provide the capital to be invested and bear the investment risk on that capital, it is right that they should be given more of a say in the management of their money.
- There is a need to align the legal framework governing investors with the 'enlightened shareholder value' ethos underpinning the duties of company directors, encouraging a responsible, long-term approach to serving beneficiaries' interests.

For a full summary of our specific recommendations to government, regulators and investors, please see pages 127-129.