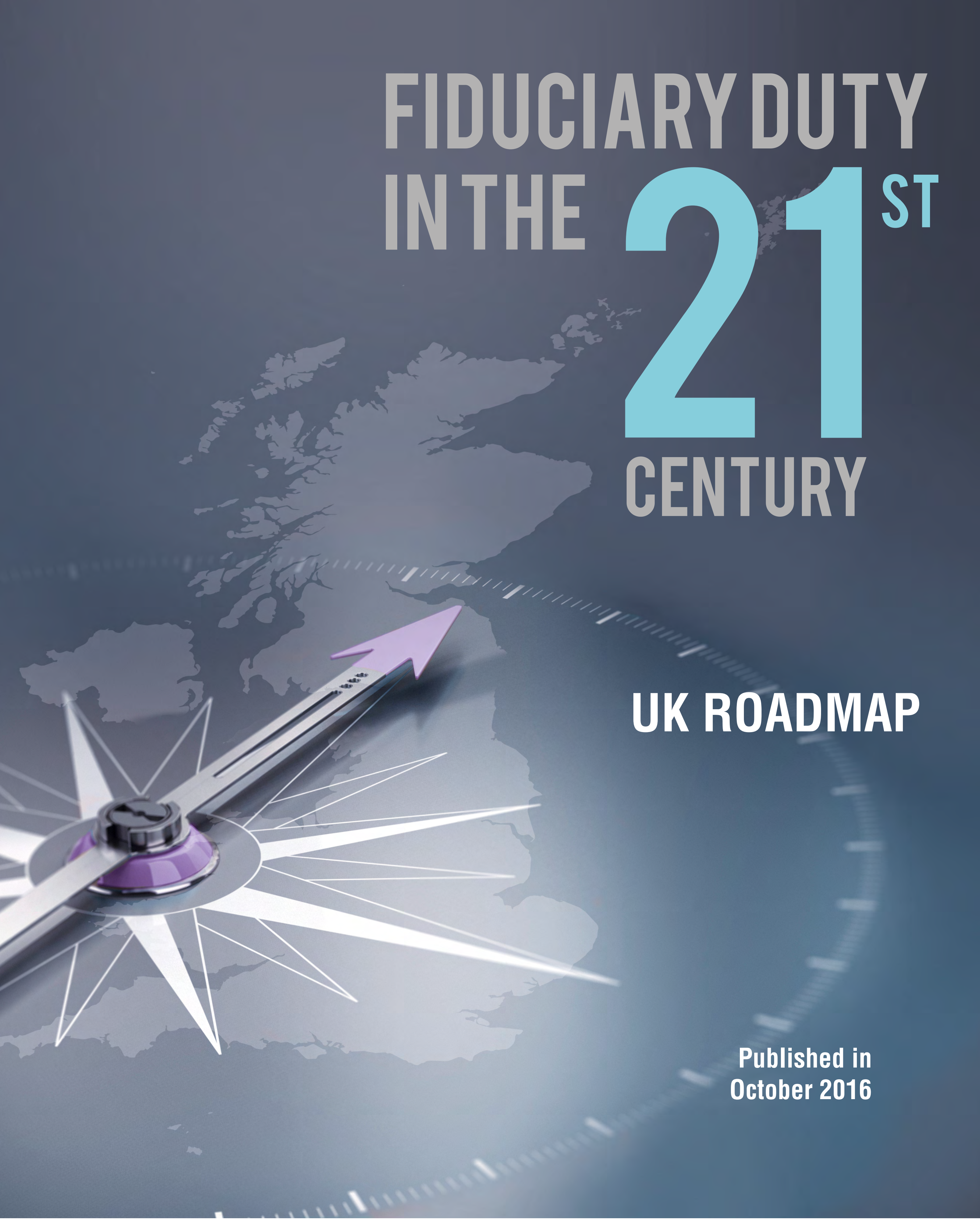
FIDUCIARY DUTY IN THE 21ST CENTURY



UK ROADMAP

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generation foundation

UNEP FINANCE INITIATIVE

PRI Principles for Responsible Investment

THE PROJECT

Fiduciary duty in the 21st century concluded that failing to consider long-term investment value drivers, which include environmental, social and governance (ESG) issues, in investment practice is a failure of fiduciary duty. Despite significant progress, many investors have yet to fully integrate ESG issues into their investment decision-making processes.

In January 2016, the PRI, UNEP FI and The Generation Foundation launched a three-year project to implement the report's recommendations, including the preparation of country roadmaps. These roadmaps enable the PRI and UNEP FI to work with national stakeholders to implement clear and accountable policy and practice that embraces the modern interpretation of fiduciary duty.

The UK roadmap was developed through extensive industry consultation and sets out recommendations in five categories: the investment regulations, stewardship and engagement, investment consultants, corporate reporting and scheme governance.

1. **The Investment Regulations:** The Department for Work and Pensions should revisit the Investment Regulations to clarify that the consideration of ESG factors is a core part of prudent investment decision-making[1].
2. **Stewardship and engagement:**
    a. Regulation and guidance should provide for a Stewardship Duty to clarify that shareholder rights are assets to be used in the best interests of beneficiaries
    b. The Financial Reporting Council should extend the Stewardship Code[2] to explicitly incorporate ESG factors and continue to monitor and publicly disclose the quality of reporting by signatories against the Code.
3. **Investment consultants:**
    a. The FCA should expand its oversight of investment advice to include that provided by investment consultants in relation to ESG factors[3].
    b. The Pensions Regulator (TPR) should provide guidance on the interaction of trustees with investment consultants to help trustees review advice and performance.
4. **Corporate reporting:** Through the implementation of the Non-Financial Reporting Directive, the development of standardised and comparable approaches for reporting on material ESG factors relevant to investors.
5. **Scheme Governance:**
    a. The governance arrangements for defined-contribution (DC) schemes should be strengthened and provide for enhanced consideration of ESG factors.
    b. Schemes should be required to reflect on the impact of their scale on governance quality and, where necessary, consider consolidation.

This work also sets the UK capital market in a broader international context, as regulators and investors respond to a rapidly-changing investing environment. Following assessment of seven further markets (Australia, Brazil, Canada, Germany, Japan, South Africa and the US), the PRI, UNEP FI and The Generation Foundation will prioritise the areas to which we will contribute.

ESG integration is defined as the systematic and explicit inclusion of material ESG factors into investment analysis and investment decisions.

PROJECT STEERING COMMITTEE

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1 The Occupational Pension Schemes (Investment) Regulations 2005: http://www.legislation.gov.uk/uksi/2005/3378/pdfs/uksi_20053378_300611_en.pdf
2 The Stewardship Code: https://www.frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx
3 As proposed in the FCA's Asset Management Market Study Interim report: https://www.fca.org.uk/your-fca/documents/market-studies/ms15-02-1-asset-management-market-study-tor

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This roadmap is prepared by the PRI, UNEP FI and The Generation Foundation and does not necessarily represent the views of interviewees and reviewers.

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Alliance Trust	Justin Atkinson	Investment Director
Asset Owners Disclosure Project	Julian Poulter	CEO
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Association of Member Nominated Trustees	Janice Turner	Founding Co-Chair
Aviva Investors	Steve Waygood	Chief Responsible Investment Officer
Barclays UK Retirement Fund	Tony Broccardo	CIO
BT Pension Scheme	Daniel Ingram	Head of Responsible Investment
CDP	Paul Dickinson	Executive Chairman
CDSB	Mardi McBrien	Managing Director
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West Midlands Pension Fund	Mark Chaloner	Assistant Director - Investments
Willis Towers Watson	Roger Urwin	Global Head of Investment Content

The project team would also like to thank Schroders for hosting the launch of the stakeholder review process in April 2016. Panellists included:

Hermes EOS	Leon Kamhi	Head of Responsibility
Pensions & Investments Magazine	Sophie Baker	London Bureau Chief
RPMI Railpen	Frank Curtiss	Head of Corporate Governance
Schroders	Jessica Ground	Global Head of Stewardship
Willis Towers Watson	Nico Aspinall	Senior Investment Consultant

STAKEHOLDER FEEDBACK

This roadmap draws on a further 30 interviews with stakeholders at different points in the UK capital market to develop and expand upon these recommendations. There were common themes in the feedback from stakeholders:

- Good governance structures in institutional investors were essential to prudent investment practices.
- The reporting of comparable, decision-relevant material ESG information by companies was key to enabling ESG integration by institutional investors.
- ESG integration had to be embedded into the organisational processes of an investor rather than being regarded as an addition to an investor's compliance burden. That requires ESG integration methodologies to be incorporated in the arrangements and performance review processes that institutional investors have with intermediaries, such as investment consultants and investment managers.
- In the context of increasing reliance on low-cost, passive investment strategies, stakeholders noted the importance of engagement with investee companies as a core element of prudent investment practice.

In writing this document, we have sought a balance between regulatory action and investment practice. We have engaged with the broad trends in the UK capital market. Our focus is the fiduciary duties owed by the trustees, sponsors and oversight bodies of UK pension schemes to their beneficiaries.

We seek to ensure that the content of those duties is reflected in investment processes and decision-making. In doing so, it has been necessary to look down the investment chain, including the role of investment consultants, investment managers and ultimately, the reporting companies provide to their investors.

The recommendations we make in this document will support national stakeholders in implementing clear and accountable policy and practice that clarify investors' duties with regards to ESG factors. This work also sets the UK capital market in a broader international context, as regulators and investors respond to a rapidly changing investing environment.

FIDUCIARY DUTY IN THE UK

Fiduciary duty requires investors to consider long-term value drivers in investment processes. ESG factors are a core part of such an assessment[4].

This understanding of fiduciary duty reflects the findings of the Law Commission, in its report Fiduciary Duties of Investment Intermediaries, which stated that "there is no impediment to trustees taking account of environmental, social or governance factors where they are, or may be, financially material"[5]. It is not the origin of the factor, but rather its financial materiality which is of relevance[6].

The Law Commission guidance draws a distinction between ESG integration[7] and social investment strategies. The primary purpose in ESG integration is the delivery of a financial return. Social investment strategies also seek to achieve purposes which are not always related to the delivery of a financial return. Such strategies often involve a narrowing of the available investment universe through the screening of sectors or stocks on ethical grounds. As such, they can be distinguished from ESG integration.

The Law Commission's report further clarified that there is no requirement founded in fiduciary duty to "maximise returns"[8], an approach reflected in the wording of the Investment Regulations[9]. That guidance helps to undermine the practice of institutional investors with long-term liabilities who employ short-term, trading-heavy investment strategies and neglect long-term fundamental analysis.

The Law Commission further indicated that fiduciaries may consider systemic risks where relevant to their investment mandate[10]. Investors face a number of systemic risks, such as climate change. Climate change may significantly alter the investment rationale for particular sectors, industries and geographies and may have generalised negative impacts on economic output. Broadly diversified institutional investors are universal owners and, in effect, "own the market", making diversification from generalised risks impossible. Given this, broadly diversified institutional investors should pro-actively identify and assess systemic risks as part of prudent investment decision-making[11]. Investors should adjust their analytical capacities to identify, integrate and provide transparency on their management of such long-term systemic risks[12].

Ultimately, fiduciary duty is interpreted by the courts through equitable common law principles that are fundamentally adaptive; adjusting to new products, investment norms and analytical approaches. The content of a prudent investment process is not static. Over the decades, investors have refined and extended their analysis and regulators have adjusted their disclosure requirements to include liquidity, capital structure, derivative instruments and off-balance-sheet transactions[13]. The consideration of ESG issues is part of the analytical framework that a prudent investor requires to understand the financial prospects and operational performance of investee companies and the risk and reward profiles of their portfolios.

4 Fiduciary Duty in the 21st Century: http://www.unepfi.org/fileadmin/documents/fiduciary_duty_21st_century.pdf

5 Fiduciary Duties of Investment Intermediaries, UK Law Commission 2014

6 The evaluation of financial materiality is at the well-reasoned discretion of pension scheme trustees having taken appropriate advice.

7 The PRI defines ESG integration as "the systematic and explicit inclusion of material ESG factors into investment analysis and investment decisions."

8 Fiduciary Duties of Investment Intermediaries, UK Law Commission 2014, para 5.52

9 The Occupational Pension Schemes (Investment) Regulations, para 4 (3) (Investment by Trustees): "The powers of investment, or the discretion, must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole."

10 Large institutional investors are "universal owners" exposed to the market in its broadest sense – making an assessment of systemic risks essential to mandate

11 Ignoring climate risk risks liability for pension fund trustees and fund managers: http://www.6pumpcourt.co.uk/2016/07/ignoring-climate-risk-risks-liability-for-pension-fund-trustees-and-fund-managers-3/

12 Several asset owners have reviewed the carbon intensity of their portfolio and sought to tilt portfolios away from carbon intensive industries and sectors

13 Expansions as a result of regulatory reviews, new data, financial scandal and investor demand

The analysis of ESG factors can also be part of the work of re-orienting companies towards long-term investment horizons. Many ESG factors have near-term urgency but are also of long-term relevance to sustainable corporate performance and resilient business-models. The quality of a firm's management of its ESG risks and opportunities is often a reliable proxy for that firm's management quality[14]. Through enabling an understanding of a company's business model, its dependencies and vulnerabilities, ESG analysis can assist in an understanding of the long-term sustainability of existing financial performance.

There is also work underway at the international level to assert the modern interpretation of fiduciary duty. Governments are responding to international agreements, such as the Paris Climate Treaty, and expanded social expectations regarding the behaviour of the investment community. Our Fiduciary Duty project has secured support from a growing list of investors for an international statement seeking clarification, at national and international level of the content and requirements of investor duties[15].

14 Turning a Profit While Doing Good: https://www.brookings.edu/research/turning-a-profit-while-doing-good-aligning-sustainability-with-corporate-performance/

15 Global Statement on Investor Obligations and Duties: http://www.fiduciaryduty21.org/investor-statement.html

THE EVOLVING LANDSCAPE OF FIDUCIARY DUTY IN THE UK

The UK market for retirement products is undergoing significant structural change. 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.

DB to DC

The overall trend in UK pension provision is one of risk transfer, from defined-benefit to defined-contribution arrangements. Corporate DB schemes are generally closed to new members[16]. Auto-enrolment has led to many more people saving for a pension[17]. The number of active savers in DC plans has now surpassed those in DB plans[18], though DB assets still exceed those held in DC schemes. British retirees will increasingly receive their pension benefits through a DC structure (whether trust or contract based).

Beneficiary voice

Public scrutiny of the investment industry has increased with concern regarding its impact on society and the environment more generally. We anticipate that beneficiaries, particularly millennials[19], will want to engage with their retirement providers on environmental and social issues[20]. This will add to the rising demand for ESG information and methods.

16 Only 12% of DB schemes remained open to new members. NAPF, Annual Survey 2013

17 Number of large schemes continue to increase as market concentrates: http://www.thepensionsregulator.gov.uk/press/pn16-07.aspx

18 Number of active DC savers overtakes DB – latest DC Trust stats: http://www.thepensionsregulator.gov.uk/press/pn15-07.aspx

19 Millennials, Women and the Future of Responsible Investing: https://riacanada.ca/millennials-women/

20 How Millennials Could Upend Wall Street, https://www.brookings.edu/research/how-millennials-could-upend-wall-street-and-corporate-america/

RECOMMENDATIONS

Fiduciary Duty in the 21st Century identified the principal barriers to ESG integration in the UK. These included: a lack of regulatory guidance, out-dated advice from service providers, a lack of knowledge of ESG methods and weaknesses in corporate reporting. We identify strategic leverage points in the UK investment market for advancing the modern interpretation of fiduciary duty.

1. The Investment Regulations:

The Department for Work and Pensions should revisit the Investment Regulations to clarify that the consideration of ESG factors is a core part of prudent investment decision-making.

The government responded to the consultation on the Investment Regulations in November 2015[21]. The Department for Work and Pensions (DWP) chose not to incorporate any changes into the Investment Regulations relating to the consideration of ESG factors or stewardship. That was a missed opportunity that should be revisited.

The balance of responses to the DWP's consultation was in favour of adjusting the Investment Regulations. The IORP II Directive[22], which sets the rules governing the activities of institutions providing occupational pensions in all EU countries, enables the content of the Investment Regulations to be re-visited. We also note that in the context of the consultation in respect of the Local Government Pension Scheme, consideration of ESG factors is proposed to be incorporated into the required content for an Investment Strategy Statement.

The wording of the Investment Regulations in relation to the consideration of ESG factors does not reflect the modern interpretation of fiduciary duty. The regulations conflate ESG and ethics in a misleading fashion[23]. By requiring the statement of policy (if any) on ESG issues, the Investment Regulations create the misleading impression of optionality around the incorporation of ESG considerations into investment processes. As we have indicated, the test for consideration of a factor within the investment process is financial materiality not the origin of the factor.

We note that TPR has adjusted its guidance to trustees to take account of the Law Commission's guidance[24]. However, it remains important that the modern interpretation of fiduciary duty is reflected in scheme's decision-making processes and governing documents. A revision of the Investment Regulations would cause an across-the-board review of Statements of Investment Principles (and investment beliefs), additional to the triennial SIP review, which would re-focus attention on ESG factors. We suggest that such an amendment would also encourage trustees to re-visit mandates with investment managers to ensure that the requirements of the Investment Regulations were reflected in investment practice.

Recommendation:

A revision of the Investment Regulations should: provide that long-term factors (including ESG considerations) are a core part of prudent investment decision-making (including by asset managers); assert that best investment practice includes ESG integration, engagement with investee companies, considered use of shareholder rights and public-policy engagement in beneficiaries' best interests; and require asset owners to report transparently on how they implement their policies and statements of investment principles in their investment practice.

Next Steps:

A significant number of investors and NGOs supported revision of the Investment Regulations and will work to seek their revision informed by the principles outlined above and the findings of the Law Commission.

21 Launched on the recommendation of the Law Commission's report on the Fiduciary Duties of Investment Intermediaries

22 The Institutions for Occupational Retirement Provision directive: http://ec.europa.eu/finance/pensions/iorp/index_en.htm

23 The Investment Regulations identify a category of investment considerations identified as Social, Environmental or Ethical.

24 Evidence cited by the Government as to why the Investment Regulations did not require reform. TPR consulted widely to develop its guidance.

2. Stewardship and engagement:

a. Regulation and guidance should provide for a Stewardship Duty to clarify that shareholder rights are assets to be used in the best interests of beneficiaries.

The current law does not contain an explicit duty to engage with, or to exercise shareholder rights, in respect of investee companies[25]. The Investment Regulations merely require trustees to indicate, in the Statement of Investment Principles, scheme policy on voting (if any)[26]. The Investment Regulations are otherwise silent on other engagement activities. This suggests, unhelpfully, that voting, as a core aspect of stewardship, is an optional investment activity. Voting is also only one element of an institutional investor's package of stewardship practices. This can be contrasted with the regulatory position in the US and Canada, where the equivalent securities and pensions regulators have asserted that shareholder rights are assets of the pension scheme to be used and monitored by fiduciaries in the best interests of beneficiaries[27].

Our stakeholders indicated that developing a duty of this sort should be the subject of a collaborative drafting effort between industry stakeholders and would be required to provide sufficient flexibility for the products used by institutional investors. Through such an extension to UK regulation we are not seeking to expand the compliance burden on UK investors. Rather we are seeking to identify in regulation the value of mindful and effective voting and engagement activity and reporting against such activity. Such duty would also reflect the best practice of asset owners seeking to assert their stewardship obligations. It would also encourage asset owners to focus on the engagement practices of their investment managers.

We note that, contrary to the assertion of the Kay Review, the Law Commission found that there is generally no "look through" of fiduciary duty down the investment chain[28]. Consequently, each layer of intermediation can make the beneficiary whose money is being invested seem increasingly remote and may dilute the strength of the fiduciary protection afforded to them. An appropriately constructed stewardship duty could be a tool for strengthening the transmission of fiduciary duties in the delegated investment chain.

Recommendation:

The Investment Regulations and FCA codes should be extended to provide that shareholder rights are assets to be used in the best interests of beneficiaries. TPR and the FCA should require trustees to maintain records of voting and engagement activities, provide meaningful disclosure in respect of their engagement and stewardship practices and selectively provide explanatory rationale for votes cast. TPR and the FCA can support such developments through guidance and critical examination of scheme-disclosure practices.

Next Steps:

Stakeholders were supportive of seeking to codify a flexible stewardship duty and would look to collaboratively develop the drafting for such a duty.

25 As confirmed by the Law Commission, Fiduciary Duties of Investment Intermediaries, UK Law Commission 2014 – para 5.19

26 The Occupational Pension Schemes (Investment) Regulations, para 2 (3)(c) (statement of investment principles): "their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to the investments"

27 In Canada: Appendix I.6.6 Retention or delegation of voting rights attached to investments - Guideline for the Development of Investment Policies and Procedures for Federally Regulated Pension Plans (OSFI, 2000). In the US: 29 CFR 2509.08-2 "The fiduciary act of managing plan assets that are shares of corporate stock includes the management of voting rights appurtenant to those shares of stock"

28 Fiduciary Duties of Investment Intermediaries, para 11.115

2. Stewardship and engagement:

b. The Financial Reporting Council should extend the Stewardship Code[29] to explicitly incorporate ESG factors and continue to monitor and publicly disclose the quality of reporting by signatories against the Code.

The Kay Review asserted that stewardship is a core function of equity markets[30]. Thoughtful and well-structured stewardship practices and strategies by shareholders can drive enhanced operational and financial performance. Several studies indicate significant value-upside from sustained engagement with investee companies[31] across a range of activities and issues[32]. Stewardship activity is a long-term instrument; its benefits accrue over several years.

The UK was one of the first countries to issue a stewardship code. Overseen by the Financial Reporting Council (FRC), the Stewardship Code establishes a voluntary regime for institutional investors to report on their stewardship activities on a "comply or explain" basis. The Stewardship Code is an instrument that governments and investors around the world refer to and is used as a model for the development of other codes. In this international context, it is particularly important that the Stewardship Code embodies good practice.

Stewardship practices should be a source of competitive differentiation, particularly among investment managers. It is important that signing the code is a meaningful activity and reporting against it enables an assessment of stewardship practices. We welcome the FRC's review of the implementation of the Stewardship Code, in particular its work to tier asset-manager practices by reporting quality.

Recommendations:

The FRC should extend the stewardship code to include explicit reference to ESG factors as part of its biennial review process; the FRC should regularly report on compliance with the Code. The FRC can use such regular analysis as an opportunity to showcase good-stewardship practices by Code signatories. The FCA should strengthen Conduct of Business Rule 2.2.3 from requiring an investor to state the nature of its commitment to the Stewardship Code to a report or explain requirement against the Code[33].

Next Steps:

A number of stakeholders indicated support for these extensions to the Stewardship Code and its monitoring framework and would seek to engage with the FRC on this.

3. Investment consultants:

a. The FCA should expand its oversight of investment advice to include that provided by investment consultants in relation to ESG factors[34].

b. The Pensions Regulator (TPR) should provide guidance on the interaction of trustees with investment consultants to help trustees review advice and performance.

Both Myners[35] and Kay identified concerns regarding investment consultant practice. They found over-reliance on short-term strategies and herding around a limited range of investment models. These reports also noted that the field from which consultants were appointed was a concentrated one. This finding is confirmed in the terms of reference for the FCA asset-management market-study[36].

29 The Stewardship Code: https://www.frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx

30 The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report (July 2012)

31 SBA Florida Valuing the Vote, http://www.sustainablefinance.ch/upload/cms/user/2015_06_SBAValuingtheVote2015.pdf

32 Calpers, "Calpers Effect" Continues to Improve Company Performance, https://www.calpers.ca.gov/page/newsroom/calpers-news/2014/company-performance

33 Conduct of Business Sourcebook, p23: https://www.handbook.fca.org.uk/handbook/COBS.pdf

34 As proposed in the FCA's Asset Management Market Study Interim report: https://www.fca.org.uk/your-fca/documents/market-studies/ms15-02-1-asset-management-market-study-tor

35 Institutional Investment in the UK: A Review (Paul Myners, 2001)

36 Asset management market study - Terms of Reference: https://www.fca.org.uk/your-fca/documents/market-studies/ms15-02-1-asset-management-market-study-tor

The Pensions Act requires that investment decisions are taken upon receipt of "proper advice"[37]. The acts of trustees must be a personal and conscious act, taken not under the dictation of another. In practice, trustees have leaned heavily on the advice of their investment consultants, often seeming to interpret advice as instruction. As a result, advice from investment consultants strongly influences the asset-allocation decisions and investment strategies of UK pension schemes.

The Law Commission provided that investment consultants were not subject to FCA rules to the extent that they provide "generic advice". Decisions over the weighting of asset classes within an investment portfolio would generally be considered to be "generic advice"[38]. By contrast, advice relating to specific investments, such as the investment in a pooled fund vehicle, would be "advice on the merits"[39] and subject to FCA regulation[40].

Several studies have indicated that it is the overall asset allocation decision that has the dominant influence (along with scheme cost) in determining investment returns, rather than the selection of particular investments[41]. Stakeholders have indicated that the regulatory distinction between advice on asset-allocation and advice on specific investments was unhelpful. It should be noted that an explicit extension of FCA rules to include "generic advice" requires a significant hurdle to be crossed[42] – which the Law Commission concluded had not been met[43]. Common to the advice provided by professionals generally, investment consultants are subject to a duty of care to their clients. The duty of care is a common law standard which adapts to reflect market practice and investment industry norms.

The key strategic position of investment consultants makes analysis of their practice particularly important. It also amplifies the importance of the knowledge and intention of asset owners in their interaction with investment consultants. In this context, we strongly welcomed both the launch of the FCA's Asset Management market study in November 2015 and TPR's on-going 21st Century Trustee work[44] which focuses on the competence, capability and governance structures of trustee boards.

The terms of reference for the FCA market study highlight several concerns regarding the practice of investment consultants. These include: the basis for recommendation of managers and asset classes; the benchmarks used; the potential for trading to be incentivised over long-term investment strategies; and the strength of assessment by trustees of investment consultant activity. These are appropriate subjects for analysis. We do though consider that the terms of the FCA's study are too narrow, failing to directly address ESG issues as a potential driver of competition and a growing unmet investment industry need. Given the significant investment risk from un-assessed ESG issues, we expect the FCA to review whether an investment consultant's failure to include such factors in advice is a breach of their duty of care given the fiduciary duties of the investors they serve.

The investment consultant industry is client-facing. For asset owners to get better outcomes from investment consultants (and service providers more generally) they need to be intentional in contract framing and performance reviews[45].

37 The Pensions Act 1996, section 36 (choosing investments), paragraph 3

38 Fiduciary Duties of Investment Intermediaries, UK Law Commission 2014, paragraph 11.50

39 As defined by the Financial Services and Markets Act (2000)

40 The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, article 53.

41 The Asset Allocation Debate: Provocative Questions, Enduring Realities: http://www.vanguard.com/pdf/icradd.pdf

42 Fiduciary Duties of Investment Intermediaries, UK Law Commission 2014, para 11.61

43 Fiduciary Duties of Investment Intermediaries, UK Law Commission 2014, para 11.62

44 New research published on trustee landscape: http://www.thepensionsregulator.gov.uk/press/pn15-46.aspx

45 PLSA survey indicated investment consultant services were infrequently subject to formal review: http://www.plsa.co.uk/PressCentre/Press_releases/0389-Schemes-satisfaction-with-investment-consultants-remains-steady.aspx

TPR's work on competence, capability and governance structures of trustee boards should extend to providing guidance on best practice for trustee interaction with investment consultants. The PRI has produced guidance which TPR could develop further under its mandate[46]. This guidance indicates that trustees should review the investment beliefs and strategies of their investment consultants; assess the depth of ESG skills of all relevant investment staff (and their location within the investment consultant's business); and embed ESG reporting expectations into mandates. Management and selection of ESG issues should be a standard feature in all performance reviews, including the time horizon against which investment choices are made. In connection with this, PRI is expanding its signatory reporting framework to include investment consultants and the extent to which ESG is part of the advice, products and services made available by investment consultants to their clients[47]. This is a critical development to help enable competitive differentiation between investment consultants on the basis of ESG capabilities and strategies.

Recommendations:

The FCA should expand its market study to review the competition implications of ESG factors in investment consultant practice. It should analyse the interaction between an investment consultant's duty of care and their consideration of ESG issues in advice. TPR should issue enhanced guidance on the expected oversight and challenge by trustees of the advice and analysis of investment consultants. We set out the case for this in our recent response to TPR's 21st Century Trustee consultation exercise. In addition, asset owners should structure ESG factors into selection procedures, mandates and performance reviews with investment consultants.

Next Steps:

Stakeholders identified the FCA market study as an important intervention in the UK capital market and would support engagement with the FCA to seek an extension to their work plan in connection with the FCA market study.

4. Corporate reporting:

Through the implementation of the Non-Financial Reporting Directive, the development of standardised and comparable approaches for reporting on material ESG factors relevant to investors.

A number of stakeholder organisations engage on enhanced financial reporting; not just in the UK, but internationally. The most recent intervention is by the Financial Stability Board (FSB). In December 2015, the FSB established a Task Force on Climate-related Financial Disclosures to undertake an assessment of what constitutes efficient, consistent and effective climate-risk financial disclosures for global capital markets. The principle-based recommendations, due December 2016, will reference the work of SASB, GRI, IIRC, CDSB[48] and others, and are expected to be relevant to social and governance factors, as well as environmental factors.

Voluntary disclosure efforts have often been accompanied by assurance of ESG information[49], often to standards equivalent to those provided in conventional accounting practice. However, lack of standardisation 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.

46 How Asset Owners Can Drive Responsible Investment: Beliefs, Strategies and Mandates (produced in partnership with United Nations Environment Program – Finance Initiative and United Nations Global Compact)

47 The Draft Service Provider Reporting Framework: https://www.unpri.org/report & https://www.unpri.org/download_report/23052

48 Sustainability Accounting Standards Board (SASB), Global Reporting Initiative (GRI), International Integrated Reporting Council (IIRC), Climate Disclosure Standards Board (CDSB)

49 ICAEW – Assurance of Non-Financial Information: https://www.icaew.com/~/media/corporate/files/technical/audit%20and%20assurance/assurance/assurance%20on%20non%20financial%20information.ashx

The recent expansion of the regime for enhanced financial disclosure by UK companies is very welcome[50]. The 2013 narrative reporting regulations require a Strategic Report and a simplified Directors' Report to be delivered as part of the annual report and accounts.

The PRI responded to the Department for Business, Innovation and Skills' UK consultation on the transposition into UK legislation of the EU non-financial reporting directive in February 2016[51]. Consistent with that response, we find that investors require timely, decision-useful information on a firm's operating performance and financial prospects, of which ESG factors are a core value, to make informed voting and investment decisions and to direct meaningful engagement activities.

Recommendation:

We recommend that the following principles shape the Department for Business, Innovation and Skills' requirements for corporate disclosures:

- ESG factors should be disclosed in the same wrapper as the annual report and the other outputs of conventional accounting practice, with clear links between ESG factors and the company's business model and risk factors.
- ESG factors should over time be subject to the same levels of assurance as financial data. We suggest a phased introduction which reflects the development of the reporting frameworks for ESG factors.
- Companies should report using common performance metrics to allow for comparability, in particular, comparability by industry, portfolio and across time-series; codifying industry- and sector-specific key performance indicators for ESG factors.
- Companies should disclose additional company-specific ESG risks and opportunities.

Next Steps:

Investors were keen to see collaboration between standard-setters, investors and reporting companies to advance the development of comparable reporting metrics for ESG information. We will support investors and stakeholders' engagement on these issues.

5. Scheme Governance:

a. The governance arrangements for defined-contribution (DC) schemes should be strengthened and provide for enhanced consideration of ESG factors.

The structure of pension provision should not determine the standard of protection of beneficiaries or the existence or quality of fiduciary governance. However, this is the case in the UK market for retirement provision.

The Office of Fair Trading (OFT) report outlined serious weaknesses in the buyer-side market for DC pension products[52]. The Law Commission indicated that "there are serious problems with the law relating to contract-based pensions". Thousands of people are trapped in high-charging legacy schemes. Small schemes are often characterised by low expertise, infrequent meetings and breaches of legal requirements, such as the requirement for triennial SIP review. The Law Commission noted a general consensus that duties in contract-based schemes should be strengthened.

There has been a significant regulatory response to this analysis, namely in the form of expanded governance standards for DC schemes[53]. Independent Governance Committees (IGCs), with an independent chair, are now required for contract-based DC schemes. These are welcome but need to be strengthened.

50 Introduced, respectively, through The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 and The Companies Act 2006 (Strategic Report and Directors Report) Regulations 2013

51 (2014/95/EU)(NFR). See PRI's detailed response - https://www.unpri.org/about/pri-teams/policy

52 Defined contribution workplace pension market study: http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.oft.gov.uk/shared_oft/market-studies/oft1505

53 In force since April 2015.

Stakeholders noted that good scheme governance structures were a precursor of good ESG practices. This means that, in policy terms, ESG cannot be engaged with in isolation and requires a navigation of the different governance challenges and structures applicable across DB and DC products. The "default fund" offered under DC schemes was identified as a particular point of focus as this is the fund that the vast majority of beneficiaries will end up in (in the absence of making a particular fund choice at the point of joining the scheme). The plan sponsor was also identified as an important source of fiduciary protection and oversight of beneficiary interests in DC schemes. Sponsors also needed to provide clear and transparent information to beneficiaries, beyond restating boilerplate language or scheme policy.

Given the quality, cost savings and enhanced returns from the best-performing diversified governance structures, we think that all occupational pension beneficiaries should receive the protection of independent, diversified governance structures. We also welcome the continuation of pension provision through "not for profit" structures in the expanding field of DC provision (such as NEST[54]) as an important source of competition and innovation in pension provision.

Recommendations:

- DC plans should integrate ESG factors into all fund options, including the "default fund", in addition to the practice of offering "Green" or "SRI" badged fund options.
- DC schemes should be subject to regular review for product suitability and investment rationale, including the extent to which ESG factors are accounted for in asset allocation. This will help shorten the long-tail of poorly performing, high-charging legacy schemes.
- The terms of reference for IGCs should be extended to include long-term value creation, product suitability and engagement practices. IGCs should be made expressly subject to FCA rules and given sufficient resources to perform oversight and analysis of provider practice.
- IGCs and boards of master trusts should require Member Nominated Trustee representation reflecting the diversified board membership of traditional DB board structures[55]. Members' Panels should be mandated for all workplace pension structures and should be actively consulted on scheme investment decisions.
- The duties of scheme sponsors should be re-stated, given their fundamental role in procuring and organising pension arrangements for employees. Such oversight should be broader than an assessment of cost and contribution ratios.
- Plan sponsors should provide transparent and concise communication about the rationale for their investment decisions to their beneficiaries, including education about ESG integration.
- The FCA rules for contract-based pension schemes should be strengthened so that providers are required to act in the best interests of savers[56].

Next Steps:

We expect several stakeholder organisations to monitor the reviews and developments of IGCs and the initial research as to their effectiveness. That work will lead to further consultations with TPR and FCA over extensions to governance frameworks in collaboration with other investors and stakeholders.

54 National Employment Savings Trust: http://www.nestpensions.org.uk/

55 Member-nominated trustees and directors – putting in place and implementing arrangements: http://www.thepensionsregulator.gov.uk/docs/code-08-mnt-mnd.pdf

56 10 steps to a sustainable investment sector: http://shareaction.org/wp-content/uploads/2016/01/10stepsbriefing.pdf

5. Scheme Governance:

b. Schemes should be required to reflect on the impact of their scale on governance quality and, where necessary, consider consolidation.

There is evidence that scheme size is positively correlated with good governance and ESG practices[57]. We understand that consideration of ESG factors is as much about priorities and intention as it is about scale; several small schemes integrate ESG very well. Outsourcing to asset managers or through fiduciary management structures can also help overcome scale-related issues. But size can convey a number of advantages. It can reduce management and advisory costs through giving asset owners a better negotiating position with service providers. Scale can also embed trustee expertise and enable engagement with investee companies through in-house fund resourcing and size of holding.

The UK has a fragmented pensions market. In 2013, TPR reported that of the 6,000 DB schemes eligible for PPF protection, 2,209 had fewer than 100 members[58]. That is before considering trust-based DC schemes. It seems unlikely that pension scheme consolidation will occur at scale in the absence of further regulatory encouragement. We also note that the government has identified improving governance as a near-term policy priority. Scheme consolidation has two key sources. Firstly, trustees reflecting on the adequacy of their governance arrangements and secondly, the government ensuring that consolidation methods are less complicated. This will enable schemes to consider consolidation a reasonable option available to them.

Recommendation:

Schemes should have to reflect on whether scale has a negative impact on scheme governance and performance, including the consideration of ESG factors and costs. This should occur every three years, with the results being reported to both the scheme membership and TPR. The government should simplify the procedures for pension scheme consolidation.

Next Steps:

Stakeholders are supportive of TPR's on-going work to survey the data on scheme governance and effectiveness and will seek to identify best-practice in scheme governance in connection with that work.

57 New research published on trustee landscape: http://www.thepensionsregulator.gov.uk/press/pn15-46.aspx

58 The Purple Book: DB Pensions, Universe Risk Profile (November 2013)

About the PRI

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance issues and to support signatories in integrating these issues into investment and ownership decisions. The six Principles were developed by investors and are supported by the UN. They have more than 1,700 signatories from over 50 countries representing US$70 trillion of assets. They are voluntary and aspirational, offering a menu of possible actions for incorporating ESG issues into investment practices. In implementing the Principles, signatories contribute to developing a more sustainable global financial system. For more information, see www.unpri.org

About UNEP FI

The United Nations Environment Programme Finance Initiative (UNEP FI) is a unique global partnership between the United Nations Environment Programme (UNEP) and the global financial sector founded in 1992. UNEP FI works closely with over 200 financial institutions who have signed the UNEP FI Statements as well as a range of partner organizations to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realize the adoption of best environmental and sustainability practice at all levels of financial institution operations. For more information, see www.unepfi.org

About The Generation Foundation

The Generation Foundation ('The Foundation') is the advocacy initiative of Generation Investment Management ('Generation'), a boutique investment manager founded in 2004. The Foundation was established alongside Generation in order to strengthen the case for Sustainable Capitalism. Its strategy in pursuit of this vision is to mobilise asset owners, asset managers, companies and other key participants in financial markets in support of the business case for Sustainable Capitalism, and to persuade them to allocate capital accordingly. For more information, see www.genfound.org

CREDITS

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