

FIDUCIARY DUTY IN THE 21ST CENTURY

US ROADMAP

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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.

This roadmap was developed through extensive industry consultation and sets out recommendations to ensure that the modern interpretation of fiduciary duty is reflected in investment practice in the US. It also sets the US capital market in a broader international context as regulators and investors respond to a rapidly changing investing environment.

The roadmap makes recommendations in seven categories: investor education, corporate reporting, investment consultants, legal advice, stewardship, organizational process and disclosure, and ERISA plan governance.

RECOMMENDATIONS:

1. **Investor Education:** Trustee boards should ensure capacity and competence on ESG issues. This should be industry-led.
2. **Corporate Reporting:**
 - a. The Securities and Exchange Commission (SEC) should update Regulation S-K to ensure high quality disclosure of ESG factors.
 - b. NASDAQ and NYSE should provide ESG reporting guidance for issuers.
3. **Investment Consultants:** Industry stakeholders should build on existing guidance to plan fiduciaries and trustees on the integration of ESG factors into investment consultant services.
4. **Legal advice:** Lawyers should ensure their institutional investor clients understand the legal risk arising from a lack of prudent management of ESG factors.

5. Stewardship and Engagement:

- a. The Department of Labor should withdraw the Shareholder Right's Bulletin.
- b. The SEC should provide updated guidance on collaborative engagement between shareholders.
- c. The SEC should introduce universal proxy ballots.

6. Organisational process and disclosure:

- a. Institutional investors should work with advisors and consultants to produce best-in-class investment policy statements.
- b. The Department of Labor should request disclosure of the extent to which pension plans incorporate long-term value drivers into investment decisions and relationships with service providers.

7. **ERISA plan governance:** The Department of Labor should conduct an industry study of the governance structures of corporate pension plans.

ESG integration is defined as: “the systematic and explicit inclusion of material ESG factors into investment analysis and investment decisions”. It is an approach to investment analysis applicable across asset classes, including equities, fixed income and private equity.

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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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U.S. Securities and Exchange Commission	Mary Schapiro	Former Chair
University of Oregon	Susan Gary	Professor of Law
US SIF	Lisa Woll	CEO
Vanguard	Glenn Booraem	Principal & Fund Treasurer
	Adrienne Monley	Senior Manager, Corporate Governance
	Rob Main	Head of Corporate Governance
Yale Climate and Energy Institute	Gary Krosinsky	Independent author, educator and advisor on sustainability and investing

STAKEHOLDER FEEDBACK

This roadmap draws on over 30 interviews with stakeholders at different points in the US capital market. There were common themes in the feedback provided by stakeholders. These have formed the basis for the analysis and recommendations that follow and are summarized below.

Stakeholders noted that the proportion of assets under management in the US subject to ESG integration was growing rapidly¹. Investors were increasingly seeing the value of ESG analysis and were responding to a rising tide of client demand for ESG services. Several major US investors had become signatories to the Principles for Responsible Investment with many more seeking to join or enquiring about the principles². It was suggested that there remained misconceptions and knowledge gaps regarding ESG integration in the US³. These could be a source of scepticism and hold back its acceptance as a mainstream investment practice in parts of the US capital market. Stakeholders also sought to emphasize that ESG integration takes time to implement. It is a process and requires senior institutional support and education. In that context, it was noted that ESG integration methods were a subject of renewed focus for many investors and their industry organizations. Even where there was scepticism, there was growing interest.

Our stakeholders sought to make ESG integration an operational reality, rather than being perceived as an addition to an investor's compliance burden. This required two broad developments: firstly, the reporting of comparable, decision-relevant ESG information by corporations, and secondly, the incorporation of ESG factors and performance assessments into organizational processes and also arrangements with intermediaries, such as investment consultants and fund managers. It was broadly acknowledged that prudent investment practices were a function of sound and accountable governance structures.

In the context of increasing reliance on low-cost, passive investment strategies, stakeholders noted the importance of engagement as a core element of prudent investment practice and the mindful use of shareholder rights, such as proxy votes. Stakeholders wanted to see the quality and resourcing of engagement practices become a source of competitive differentiation between investment managers.

Litigation risk was identified as a key obstacle for schemes considering adjusting investment practices. Fiduciaries sought legal clarification of their discretion to integrate ESG and were concerned to avoid initiatives that might elevate scheme costs⁴.

Stakeholders further indicated that changes in underlying statutes were not required as they provided flexibility for ESG factors to be taken into account⁵. Several stakeholders were also concerned that seeking legislative change to make explicit reference to ESG considerations could take us "down the legal rabbit-hole"; distracting from a focus on prudent investment practice. Stakeholders were also generally resistant to expansions in regulatory remit. They noted that relying on regulatory guidance can be vulnerable to political considerations in a way that broad, market-practice-based assumptions about investment activity are not⁶. That analysis was counter-balanced by several stakeholders that identified well-framed regulatory guidance as a catalyst for plan fiduciaries to revisit governance structures and investment processes.

In developing this document, we have sought a balance between regulatory action and investment processes. We have sought to engage with the broad trends in the US capital market. We set out a series of recommendations.

1 As of 2014, 18% of investment assets under professional management in the US were subject to ESG analysis or filed ESG themed shareholder resolutions. USSIF Trends Report, 2014: http://www.ussif.org/store_category.asp?id=4

2 PRI Signatory Directory: <https://www.unpri.org/signatory-directory/?co=235&sta=&sti=&sts=&sa=join&si=join&ss=join&q=>

3 Misconceptions based on out-dated data and approaches which associated ESG with exclusively "ethical investment" and diminished returns. Both misconceptions which we address below.

4 Particularly cited in respect of ERISA governed plans

5 Confirming the analysis set out in Fiduciary Duty in the 21st Century

6 Citing ERISA guidance issued under different administrations as an example

THE EVOLVING LANDSCAPE FOR FIDUCIARY DUTY IN THE US

Regulators and government agencies in the US have confirmed interpretations relevant to fiduciary investment practice in recent years. In Interpretive Bulletin 2015-01 released in October 2015 (the ESG Bulletin⁷), the Department of Labor clarified that ESG factors can be part of the “primary analysis” of prudent investment decision-making by ERISA fiduciaries⁸. The ESG Bulletin may prove catalytic for the acceptance of ESG integration, particularly among skeptics. However, for many investors, the ESG Bulletin was simply a confirmatory statement of the appropriate content of prudent investment processes. In Notice 2015-62: Investments Made For Charitable Purposes, the Internal Revenue Service (IRS) provided that: “foundation managers may consider all relevant facts and circumstances, including the relationship between a particular investment and the foundation’s charitable purposes”. This helps to increase the freedom for foundations to pursue mission-driven investment in a manner consistent with their fiduciary duties.

We note that within the core fiduciary duties of prudence and loyalty are the duty of impartiality⁹ and the duty to monitor¹⁰, which have become subjects of renewed focus. In seeking to balance the interests of plan participants, the duty of impartiality should cause a fiduciary to consider the interests of beneficiaries who may not retire for 30 years, as well as those who are current retirees. Fiduciaries are also required to subject their existing investments to critical analysis, understanding that the basis of an investment changes over time and should be monitored. This is particularly relevant given the known trends and uncertainties in the regulatory landscape and economic rationale for carbon intensive industries¹¹.

The overall trend in US pension provision is one of risk transfer. Corporate defined benefit (DB) schemes are closing to new members and converting provision to defined contribution (DC) arrangements. Schemes are entering into de-risking arrangements when their funding position allows. DC or IRA arrangements dominate new pension product offerings. This structural change makes the passage of the Fiduciary Rule¹² regarding retirement advice particularly important for plan participants. DC plans are also seeking to reduce costs and plan options in response to cost based litigation against ERISA fiduciaries. We note that DB plans have significant advantages in terms of income replacement and beneficiary security which are generally not reflected in DC arrangements.

Public scrutiny of the investment industry has increased with concern regarding its impact on society and the environment. We anticipate that beneficiaries, particularly millennials¹³, will want to engage with their retirement providers on environmental and social issues¹⁴. This will add to the rising demand for ESG information and methods.

7 Interpretive Bulletin Relating to the Fiduciary Standard under ERISA in Considering Economically Targeted Investments – also known as the ETI Bulletin

8 ERISA guidance has inferential weight for non-ERISA governed plans, as many share the same fiduciary standard

9 *Varity Corp v Howe et al.*, 516 U.S. 489 (1996)

10 Glenn Tibble, et al., *Petitioners v Edison International, et al.*, 13-550 (2015)

11 Plan Sponsor, World’s Largest Coal Company Faces ERISA Suit: <http://www.plansponsor.com/Worlds-Largest-Coal-Company-Faces-ERISA-Suit/>

12 The revised Fiduciary Rule became effective on June 7, 2016 and will be applied from April 10, 2017 significantly extends the range of investment intermediaries whose advice would be subject to a higher fiduciary standard

13 RIA. Millennials, Women, and the Future of Responsible Investing: <https://riacanada.ca/millennials-women/>

14 Brookings Institute, How Millennials Could Upend Wall Street: http://www.brookings.edu/~media/research/files/papers/2014/05/millennials%20wall%20st/brookings_winogradv5.pdf

RECOMMENDATIONS

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.

1. Investor Education:

Trustee boards and plan fiduciaries should ensure capacity and competence on ESG issues. This should be industry-led.

The incorporation of ESG factors into investment processes and research is a critical addition to the analytical tool-kit available to investors in assessing investee companies, constructing investment portfolios and driving enhanced returns¹⁵. ESG factors have been an essential part of long-term fundamental investment management processes for many years – without the use of the label “ESG”¹⁶. Management of ESG factors can also be a source of enhanced operational performance and financial prospects in investee companies¹⁷.

The PRI defines ESG integration as “the systematic and explicit inclusion of material ESG factors into investment analysis and investment decisions”. A recent PRI report indicates that investors can treat ESG factors in the same way as any other financial factors using existing quantitative methodologies¹⁸. Neglecting analysis of ESG factors may cause the mispricing of risk and poor asset allocation decisions. It is worth clarifying that, in our view, ESG integration does not necessarily involve a narrowing of the available investment universe (unlike negative screening)¹⁹. Neither does it involve relegating the pursuit of a financial return to unrelated objectives (social or ethical). It does though provide investors with an expanded set of tools for evaluating the operational performance

and financial prospects of investee companies. ESG analysis is increasingly assisting investors to identify value-relevant factors undetected by out-dated financial-only analysis²⁰.

The content of a prudent investment decision changes over time. We can see this in the expansion of the disclosure requirements under Regulation S-K²¹. Over recent decades that framework has expanded to include reporting on a corporation’s liquidity, capital structure, derivative instruments and off-balance sheet transactions. This reflects the evolving tools and techniques of prudent investment analysis. It is important to understand that ESG integration is less a product than it is part of the broader process and technology of investment analysis. Ultimately, the consideration of ESG factors has become one of the core characteristics of a prudent investment process.

Investors also face a number of systemic risks, such as the stability of systemically important financial institutions and the impacts of climate change. Climate change may significantly alter the investment rationale for particular sectors, industries and geographies and may have generalized negative impacts on economic output. Broadly diversified institutional investors are universal owners and, in effect, “own the market”, making diversification from generalized risks impossible. Given this, systemic risks, particularly those arising from ESG issues, should be pro-actively identified and assessed as part of prudent investment decision-making²². Investors should adjust their analytical capacities to identify, integrate and provide transparency on their management of such long-term systemic risks²³.

15 SBA Florida, Valuing the Vote: <https://www.sbafla.com/fsb/Portals/Internet/CorpGov/ReportsPublications/SBAValuingtheVote2015.pdf> & “Calpers Effect” Continues to Improve Company Performance: <https://www.calpers.ca.gov/page/newsroom/calpers-news/2014/company-performance>

16 Several investment managers said they considered all valuation-relevant factors, no matter what their origin –without specifically categorizing them under the ESG label

17 Robert Eccles, Ioannis Ioannou and George Serafeim. (2012) the Impact of Corporate Sustainability on Organization Processes and Performance: http://www.hbs.edu/faculty/Publication%20Files/SSRN-id1964011_6791edac-7daa-4603-a220-4a0c6c7a3f7a.pdf

18 PRI Reporting Framework 2016 Main Definitions: <https://www.unpri.org/page/pri-launches-esg-integration-guide-for-equity-investors>

19 For some investors, ESG integration is pursued in concert with negative screens.

20 ESG Research Works: <https://www.ft.com/content/b22c49c8-06e8-11e2-92ef-00144feabdc0>

21 Securities and Exchange Commission, Business and Financial Disclosure Required by Regulation S-K: <https://www.sec.gov/rules/concept/2016/33-10064.pdf>

22 Calstrs, Investment Policy and Management Plan: http://www.calstrs.com/sites/main/files/file-attachments/a_-_investment_policy_and_management_plan.pdf

23 Unhedgeable risk: How climate change sentiment impacts investment: <http://www.cisl.cam.ac.uk/publications/sustainable-finance-publications/unhedgeable-risk>

It is important that ESG integration be broadly available as a tool of investment analysis. This makes fiduciary training and the publication of the investment case for ESG integration of strategic importance.

Recommendations:

All trustee and fiduciary on-boarding procedures should embed skills and awareness of ESG analytics as part of the core competencies of trustees and scheme fiduciaries – and be set out as a requirement in fiduciary education. Trustee boards and plan fiduciaries should annually review their balance of skills and competencies²⁴; familiarity with ESG analytics and methodologies should be a fundamental part of that assessment. Investment consultants should advise their clients as to ESG risks and analysis.

Next steps:

The PRI is working with signatories and industry stakeholders to develop ESG tool-kits and trustee training programs to raise awareness of ESG methodologies and benefits²⁵. This is part of work by a broad range of organisations such as SASB, CFA, Ceres and USSIF to raise awareness of ESG practices and develop methodologies to ease their adoption. To overcome misperceptions and knowledge-gaps, US investment consultants and asset managers should use a dedicated portion of their recurring client conferences to showcase ESG integration practices (methodologies, return attribution, engagement).

2. Corporate Reporting:

a. The SEC should update Regulation S-K to ensure high quality disclosure of ESG factors.

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 modelled.

The 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 for investors²⁶.

The SEC, through Regulation S-K, provides an existing corporate reporting architecture and a materiality standard familiar to the investment industry. The SEC provided Interpretative Guidance in 2010 that Regulation S-K required disclosure of material risks related to climate change²⁷. Investor feedback and the convening of the FSB Task Force on Climate-related Financial Disclosures indicate that reporting companies' response to this guidance was inadequate – with low quality or boilerplate disclosures being the norm. Existing guidance has not been sufficient to create a perceived industry requirement to disclose against ESG factors. Yet there is significant demand for standardized ESG reporting standards and an improvement in the quality and comparability of ESG reporting generally.

Recommendations:

We recommend that the SEC update Regulation S-K to ensure high quality disclosure of ESG factors. The PRI has set out recommendations to the Commission in its response to the Concept Release on Regulation S-K²⁸.

Consistent with that response, we recommend that the following principles shape the Commission's 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 overtime be subject to assurance as with financial data. We suggest a phased introduction.

24 In the same way that corporate boards are required to consider board competency under Sarbanes-Oxley

25 PRI Investment Practices: <https://www.unpri.org/about/pri-teams/investment-practices>

26 Though it is accepted that corporate information not directed at sophisticated investors may still be of relevance to an investor conducting ESG analysis

27 Securities and Exchange Commission, Commission Guidance Regarding Disclosure Related to Climate Change: <https://www.sec.gov/rules/interp/2010/33-9106.pdf>

28 Securities and Exchange Commission, Business and Financial Disclosure Required by Regulation S-K <https://www.sec.gov/rules/concept.shtml>

- Corporations should report using common performance metrics to allow for comparability, in particular, by industry, portfolio and across time-series.
- Corporations should disclose additional company-specific ESG risks and opportunities.

In addition, we note that SEC Staff Comment letters can drive disclosure practices both at the level of the registrant and the market generally. We recommend that the SEC continue to make the analysis set out in their Staff Comment Letters publicly available. In connection with the Regulation S-K consultation, we would welcome the Commission focusing staff effort on the analysis and improvement of disclosure of ESG information.

Next steps:

Significant collaborations between investors and supportive organizations will continue to support the SEC following the close of the Regulation S-K concept release comment period²⁹. We expect significant work to follow on from the report by the FSB Task Force on Climate-related Financial Disclosures, supported by institutional investors and ESG standard setters to exert investor pressure to promote ESG disclosures by US issuers.

2. Corporate Reporting:

b. NASDAQ and NYSE should provide ESG reporting guidance for issuers.

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. To date, 16 exchanges have introduced guidance³⁰ for reporting on ESG indicators with several more committed to produce guidance this year³¹. Guidance by exchanges can enhance the consistency and comparability of ESG information available to investors. 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 requirements³².

Recommendation and next steps:

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. Stakeholders will continue to work with the UN Sustainable Stock Exchanges initiative and other stakeholders to push for such guidance to be issued.

²⁹ Towards a sustainable economy: <http://www.citizen.org/documents/SustainableEconomyReport.pdf>

³⁰ This includes exchanges that promote guidance from other standard setters or regulatory bodies, such as JSX adopting the King Code in South Africa.

³¹ The SSE Campaign to Close the Guidance Gap: <http://www.sseinitiative.org/engagement/esg-guidance/>

³² See recommendations regarding Regulation S-K above.

3. Investment consultants:

Industry stakeholders should build on existing guidance to plan fiduciaries and trustees on the integration of ESG factors into investment consultant services.

Investment consultants strongly influence the investment strategies and resulting asset allocation decisions of US pension schemes. They also act as a selection mechanism in respect of investment managers and provide training to sponsors and trustees on investment approaches and emerging investment trends. Investment consultants are regulated under the Investment Advisers Act of 1940 (the Advisers Act) which provides for a fiduciary duty to provide disinterested advice to their clients³³. Though decisions regarding asset allocation or manager selection are ultimately those of the relevant plan, in practice, trustees and plan sponsors lean heavily on the advice of their investment consultants – often seeming to interpret advice as instruction³⁴. We note that under ERISA, an investment consultant is likely to be a plan fiduciary as a result of the provision of investment advice to the plan³⁵.

In this context, sponsors and trustees should be supported with guidance. Such guidance should outline methods for interacting with investment consultants to drive value and ensure that advice and investment processes are subject to searching analysis. Given the content and requirements of fiduciary duties, plan sponsors and trustees should be assisted in interrogating whether their consultants are reflecting the fiduciary duties against which they are held in the scope and content of their investment advice.

Practical recommendations on interactions between plan sponsors and trustees and investment consultants could be made, to ensure the consideration of material ESG issues in investment processes.

Guidance could indicate that plan sponsors and trustees request and review their investment consultant's stated investment strategies; request an assessment of the depth of ESG skills of relevant staff (and their location within the investment consultant's business); and embed ESG reporting expectations into mandates and performance reviews of investment consultant practice – including the time-horizon against which investment choices are being made and assessed³⁶.

We note that as ERISA plans are regulated by the Department of Labor and the Advisers Act is overseen by the SEC, there is a role for joint guidance to be issued which would be of use to all plan sponsors and trustees. There is precedent for such joint guidance³⁷ – in which the SEC and the Department of Labor issued a series of questions for plan sponsors and trustees to ask their investment consultants on conflicts of interest³⁸. We also note that The Pensions Regulator in the United Kingdom³⁹ has recently concluded a consultation regarding expanding its suite of guidance to include scheme fiduciaries' interaction with service providers, such as investment consultants⁴⁰.

Recommendation and next steps:

We expect key industry stakeholders to develop and build on existing guidance to plan fiduciaries and trustees in their interactions with investment consultants on ESG factors. Following international trends, we would expect US regulators overtime to adopt such guidance.

33 In addition to disclosing conflicts of interest.

34 To an extent this reflects the expected interaction between investment professionals (as service providers) and lay-people (as clients) – where the expert can significantly influence client outlook

35 Section 3(21) ERISA

36 Further guidance is set out in - [How Asset Owners Can Drive Responsible Investment: Beliefs, Strategies and Mandates](#) (produced by the PRI in partnership with United Nations Environment Program – Finance Initiative and United Nations Global Compact)

37 Securities and Exchange Commission, Selecting and Monitoring Pension Consultants: Tips for Plan Fiduciaries: <https://www.sec.gov/investor/pubs/sponsortips.htm>

38 Department of Labor, Selecting and Monitoring Pension Consultants- Tips for Plan Fiduciaries: <https://www.dol.gov/ebsa/newsroom/fs053105.html>

39 Which has a somewhat similar remit to EBSA within the Department of Labor

40 The Pensions Regulator, 21st century trusteeship and governance discussion paper: <http://www.thepensionsregulator.gov.uk/doc-library/21st-century-trusteeship-and-governance-discussion-2016.aspx>

4. Legal advice

Lawyers should ensure their institutional investor clients understand the legal risk arising from ESG factors.

PRI released guidance in February 2016 by Morgan, Lewis and Bockius and Groom Law Group on fiduciary duty in the US reflecting the content of the ESG Bulletin⁴¹. This is the start of a program to adapt the default legal guidance given to the investment community. The report, *Fiduciary Duty in the 21st Century*, identified out-dated and narrow legal interpretations of fiduciary duty as a significant barrier to ESG integration and our stakeholder engagement interviews have confirmed that legal guidance is a significant impediment to progress.

We seek to engage with the legal community to adjust the mainstream perception of the litigation risk for ESG integration. Litigation risk has often been cited as a reason not to integrate ESG. For ERISA governed plans, this has been informed by the volume of class-action cases brought against scheme fiduciaries in recent years. Though the causes of action were not associated with ESG, the volume of litigation has caused scheme fiduciaries to be reluctant in adopting new scheme practices. We consider that recent causes of action⁴², legal commentary, particularly in the context of climate change⁴³, and the volume of funds using ESG integration techniques are part of the context adjusting the balance of litigation risk. A lack of integration of ESG factors into investment processes is emerging as a source of significant legal and financial risk⁴⁴. We note that all professionals have a duty of care towards their clients to highlight matters of relevance to their business.

Recommendation and next steps:

To engage with law firms that advise plan fiduciaries to raise awareness of ESG integration issues. We will collaborate with legal advisers to develop further legal guidance to clarify the legal risks arising from a lack of prudent management of ESG factors in investment portfolios.

5. Stewardship and engagement:

a. The Department of Labor should withdraw the Shareholder Right's Bulletin.

Shareholders play a critical role in corporate governance⁴⁵. Enhanced shareholder engagement has seen changes in board election practices, executive compensation and, in some instances, corporate strategy⁴⁶. Engagement assists shareholders in making informed voting decisions in respect of investee companies and has moved, in short-order, from the margins to the mainstream⁴⁷ - a year-round activity, not one simply precipitated by an annual general meeting or corporate crisis. Engagement is an instrument for creating long-term value and is a central element in the prudent oversight of investee companies.

We note that engagement on ESG issues with investee companies is the core ESG integration practice for many investors⁴⁸. ESG themes have proved a dominant topic for shareholder resolutions⁴⁹. These resolutions are now obtaining support from increasingly larger proportions of shareholders in voting returns⁵⁰.

41 PRI presents legal perspectives on addressing ESG factors under ERISA: <https://www.unpri.org/news/pri-presents-legal-perspectives-on-addressing-esg-factors-under-erisa>

42 Plan Sponsor, World's Largest Coal Company Faces ERISA Suit: <http://www.plansponsor.com/Worlds-Largest-Coal-Company-Faces-ERISA-Suit/>

43 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/>

44 Peabody Settlement Shows Muscle of Law Now Aims at Exxon: <https://insideclimatenews.org/news/10112015/peabody-coal-climate-change-settlement-new-york-ag-exxon-subpoena-investigation>

45 U.S. Securities and Exchange Commission, Remarks at the 10th Annual Transatlantic Corporate Governance Dialogue: <https://www.sec.gov/News/Speech/Detail/Speech/1370540434901#.VLv9j>

46 For example: the wide adoption of majority voting practices in director elections; board de-classification; and proxy access

47 Four takeaways from proxy season 2015: <http://www.ey.com/GL/en/Issues/Governance-and-reporting/EY-four-takeaways-from-proxy-season-2015#company-investor-engagement>

48 Particularly for long-hold equity positions or passive, indexed investment vehicles

49 Submitting resolutions has been practiced by collaborative engagement forums for many years (eg ICCR, Ceres INCR).

50 Report on US Sustainable, Responsible and Impact Investing Trends: http://www.ussif.org/store_category.asp?id=4

Several well-informed guides on engagement have been published⁵¹ and investors are becoming more assertive in reporting on their engagement practices⁵². It is understood that best engagement practices⁵³ may produce significant efficiencies for both investors and boards of investee companies⁵⁴. In the context of these trends, we seek to enable the quality, consistency and outcomes from engagement with investee companies to be a source of competitive differentiation among asset managers and an indicator of best practice between asset owners.

We recommend that the Department of Labor withdraw and re-issue its Interpretive Bulletin from October 2008 (29 CFR 2509.08-1)⁵⁵ applicable to ERISA fiduciaries (the Shareholder Rights Bulletin). The Shareholder Rights Bulletin has had the effect of raising doubts as to the circumstances in which ERISA fiduciaries are able to engage with investee companies and vote proxies. Where many institutional investors have sought to engage with shareholder resolutions on ESG issues, stakeholders indicated that many ERISA investors have felt less able to do so. This is broadly the result of the Shareholder Rights Bulletin indicating that engagement and proxy use on environmental and social issues would be rare.

We note that in the ESG Bulletin issued in October 2015, the Department clarified that ESG factors could be part of the “primary analysis” of a prudent investment decision. In a series of advisory letters, the Department stated that the fiduciary duties (of prudence and loyalty) require plan fiduciaries “to vote proxies appurtenant to shares of stock” and that “the decision as to how proxies should be voted with regard to the issues presented by the fact pattern are fiduciary acts of plan asset management”. The Shareholder Rights Bulletin’s seemingly hostile view on proxy voting and shareholder

engagement with investee companies seems inconsistent with the Department’s guidance expressed in the ESG Bulletin and a drag on prudent engagement by ERISA fiduciaries.

Next steps:

Stakeholders have expressed support for existing efforts to encourage the Department of Labor to withdraw the Shareholder Rights Bulletin.

5. Stewardship and engagement:

b. The SEC should provide updated guidance on collaborative engagement between shareholders.

We note that the SEC has sought to address corporations’ concerns regarding informal conversations it may convene with shareholders in a manner that avoids infringing Regulation FD⁵⁶. Investor uncertainty remains, however, around the extent to which shareholders may talk to each other regarding investee companies⁵⁷. This is a concern confirmed by PRI signatories and our stakeholder engagement interviews⁵⁸. Such interpretations can chill the extent of collaborative engagement that investors are comfortable to pursue regarding investee companies on ESG issues. The SEC has previously indicated that it was taking a closer look at Wolf Pack situations⁵⁹ - where activist hedge funds informally act in relation to an issuer without disclosure. We note that in the UK, the Financial Conduct Authority⁶⁰ has clarified in its code of conduct that conversations between investors are not acting in concert – enabling a more permissive regime for inter-shareholder dialogue regarding investee companies.

51 BlackRock & Ceres, 21st Century Engagement: <http://www.breckinridge.com/Ceres%20&%20BlackRock%2021st%20Century%20Engagement%20Guide.PDF> & How institutional investors should step up as owners: <http://www.mckinsey.com/business-functions/risk/our-insights/how-institutional-investors-should-step-up-as-owners>

52 SBA Florida, Corporate Governance Annual Summary 2015: http://www.sbafla.com/fsb/Portals/FSB/Content/CorporateGovernance/Reports/2015_SBACorporateGovernanceAnnualSummaryV2.pdf & State Street Global Advisors, Annual Stewardship Report 2015 Year End: <https://www.ssga.com/investment-topics/environmental-social-governance/2016/2015-Annual-Stewardship-Report.pdf>

53 SDX, What is the SDX Protocol?: <http://www.sdxprotocol.com/what-is-the-sdx-protocol/>

54 Gender Diversity and Corporate Performance: <https://publications.credit-suisse.com/tasks/render/file/index.cfm?fileid=88EC32A9-83E8-EB92-9D5A40FF69E66808> & Why diversity matters: <http://www.mckinsey.com/business-functions/organization/our-insights/why-diversity-matters>

55 Interpretive Bulletin Relating to Exercise of Shareholder Rights: <https://www.federalregister.gov/articles/2008/10/17/E8-24552/interpretive-bulletin-relating-to-exercise-of-shareholder-rights>

56 U.S. Securities and Exchange Commission, Section 101. Rule 100: General Rule Regarding Selective Disclosure: <https://www.sec.gov/divisions/corpfin/guidance/regfd-interp.htm>

57 Anti-trust rules and acting in concert disclosures among them

58 See also IRRCi: <http://irrcinstitute.org/wp-content/uploads/2015/09/engagement-between-corporations-and-investors-at-all-time-high1.pdf>

59 The SEC Doesn’t Like it When Hedge Funds Talk to Each other: <https://www.bloomberg.com/view/articles/2015-06-05/the-sec-doesn-t-like-it-when-hedge-funds-talk-to-each-other>

60 Essentially the UK equivalent of the SEC

Next Steps:

Stakeholders support confirmatory guidance on collaborative engagements between US investors.

5. Stewardship and engagement:**c. The SEC should introduce universal proxy ballots.**

The role of shareholder oversight should be affirmed and procedural obstacles removed wherever they exist. We note that the SEC's proxy access procedures were vacated. Proxy access has subsequently been addressed on a company-by-company basis and a broad market practice is developing around the appropriate thresholds at which proxy access can be obtained. In that context, we understand that the SEC has begun to review proposals for universal proxy ballots such that director candidates would be listed on the same proxy ballot form, rather than separate forms for management nominees and shareholder nominees⁶¹.

Next steps:

Institutional investors should continue to collaborate to support proposals for rules enabling universal proxy ballots⁶².

Institutional Investors - best practice:

Institutional investors should provide public analysis of their engagement and stewardship activities⁶³. To enable engagement to become a source of competitive differentiation, institutional investors should identify the resources that they have made available for engagement activities and the location of professionals within the business with responsibility for engagement activity.

6. Organisational process and disclosure:**a. Institutional investors should work with advisors and consultants to produce best-in-class Investment Policy Statements.**

Investment Policy Statements are key documents in framing an institutional investor's outlook and also in signalling its preferences to service providers⁶⁴. Not all schemes are required to have an Investment Policy Statement⁶⁵, but best practice suggests that schemes ought to have one. The content of such statements are an outgrowth of several factors⁶⁶ and set out scheme practice, procedures and objectives (which in our view should include the extent to which ESG integration is part of scheme practice).

Best practice suggests that where a plan has an Investment Policy Statement, it should be subject to routine annual review. In an investment environment which is far from static and where analytical tools and frameworks are constantly adjusting, institutional investors should make comprehensive reviews of Investment Policy Statements a priority. Following guidance by the Department of Labor and the IRS, we would expect ERISA, endowment and foundation fiduciaries to be considering comprehensive Investment Policy Statement reviews. We are aware that several State Plans have recently undertaken comprehensive investment belief and Investment Policy Statement review processes.

Developing or revisiting such statements is a deliberative process for fund fiduciaries, requiring time and extensive input from professional advisers. It can be a powerful tool for organizational learning and an opportunity to engage with the requirements fiduciary duty imposes on their institution.

61 SEC Chair says agency will propose 'universal proxy ballot' rules: <http://www.reuters.com/article/us-sec-proxy-rules-idUSKBN0P51V020150625>

62 CII Universal Proxy: http://www.cii.org/cii_universal_proxy

63 Having regard for capacity and resource constraints

64 Developing an Investment Policy Statement Under ERISA: <http://www.morganstanleyfa.com/public/facilityfiles/mssb866205/c92f47a9-e3a3-468a-8b88-2361defdd966.pdf>

65 For instance, an Investment Policy Statement is not required by ERISA though many plans have them. Public plans and foundations tend to have Investment Policy Statements, many of which are publicly available.

66 Fiduciary duties, the applicable regulatory regime, the time-horizon of the liabilities for which they are investing, product mix offered.

Recommendation and next steps:

Stakeholders should work with investment consultants and fiduciary advisers to develop and publicize best-in-class Investment Policy Statements building on existing guidance. Industry bodies can also support and encourage Investment Policy Statement review by re-visiting guidance provided to member organizations⁶⁷. The PRI's work on developing investment strategies, investment policy statements and investment beliefs can also help frame and inform these processes⁶⁸.

Institutional investors – best practice:

Each institutional investor should set out a public statement of its understanding of its fiduciary responsibility and how this interacts with its investment practice. We note that several state public funds have such statements⁶⁹ and several foundations make their Investment Policy Statements public⁷⁰.

6. Organisational process and disclosure:

b. The Department of Labor should request disclosure of the extent to which pension plans incorporate long-term value drivers into investment decisions and relationships with service providers.

Regulators outside the US have increasingly required statements explaining ESG investment practices, such as the recent requirement by the Financial Services Commission of Ontario

(FSCO) that pension funds disclose the extent to which they take account of ESG factors in investment processes⁷¹.

The FSCO notes that the decision to incorporate ESG factors is in line with pension administrators' fiduciary duty to monitor and mitigate risk, and that transparency around the fund's policy is critical information for beneficiaries⁷². Such disclosures have been a feature of UK pensions regulation for a decade⁷³.

ERISA fiduciaries disclose a broad range of information annually on Form 5500 and are subject to record-keeping provisions. The Government Accountability Office has repeatedly examined the issue of effective disclosure by ERISA governed plans⁷⁴ and identified extensions and improvements⁷⁵. We note that the Department of Labor has recently issued a proposed rule to significantly adjust the format and extent of annual disclosures by ERISA governed plans⁷⁶. The proposed rule is intended to "allow the Agencies and the interested public to monitor a larger number of pension plans and their asset allocations" and "lead to more competition and improved plan performance". We welcome this initiative as the beginning of a broader process of expanded scheme disclosure and analysis – by both the Department, participants and plan analysis groups.

We note that Mutual Funds are required to disclose policies and procedures for voting shares in investee companies⁷⁷ and their record of proxy votes⁷⁸. Voting policies are often unspecific, with broad "case-by-case" voting flexibility. Attention is being given to simplifying the comparison of mutual fund voting practices to enable manager ratings to be widely developed⁷⁹.

67 For instance, the Government Financial Officers Association (GFOA) has issued a Sample Investment Policy.

68 Crafting an investment strategy: <https://www.unpri.org/about/pri-teams/investment-practices>

69 CalPERS Beliefs: <https://www.calpers.ca.gov/docs/forms-publications/calpers-beliefs.pdf>

70 Glass Pockets Transparency Trends: <http://glasspockets.org/glasspockets-gallery/transparency-trends>

71 Financial Services Commission of Ontario FAQs – Statement of Investment Policies and Procedures: <https://www.fSCO.gov.on.ca/en/pensions/legislative/Pages/sipp.aspx#ESG>

72 Financial Services Commission of Ontario, Investment Guidance Notes: IGN-004: Environmental Social and Governance (ESG) Factors, <https://www.fSCO.gov.on.ca/en/pensions/policies/active/Documents/IGN-004.pdf>.

73 The Occupational Pension Schemes (Investment) Regulations 2005: <http://www.legislation.gov.uk/ukSI/2005/3378/regulation/2/made>

74 United States Government Accountability Office, Additional Transparency and Other Actions Needed in Connection with Proxy Voting: <http://www.gao.gov/assets/250/243646.pdf>

75 United States Government Accountability Office, Targeted Revisions Could Improve Usefulness of Form 5500 Information: <http://www.gao.gov/products/GAO-14-441>

76 Department of Labor EBSA, RIN 1210-2590: <https://s3.amazonaws.com/public-inspection.federalregister.gov/2016-14892.pdf>

77 Form N1-A

78 Form N-PX

79 Sustaining sustainability: What institutional investors should do next on ESG: <http://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/sustaining-sustainability-what-institutional-investors-should-do-next-on-esg?cid=other-eml-alt-mip-mck-oth-1606>

In this, as in other contexts, disclosure may also drive engagement. By providing for expanded disclosures in a prescribed format, regulators can enable inter-investor comparability and differentiation.

Recommendation and next steps:

As part of expanded disclosure for ERISA governed plans, the Department of Labor should request disclosure of the extent to which long-term value drivers are incorporated into investment decisions and relations with scheme service providers – such as through asset manager mandates. The SEC should review the regime for disclosure of mutual fund voting to enhance comparability. We would support proposals for data tagging disclosures on Form N-PX⁸⁰. Stakeholders are working to identify and publicize the best international disclosure practices and the benefits of such disclosures.

Institutional investors – best practice:

Asset owners should report on voting decisions⁸¹ and selectively provide rationale for voting decisions (such as for consequential votes and votes against management). The vote is a market signal in a way private engagement with a corporation is not. Disclosure of rationale for votes cast enables an understanding of the disposition of asset owners and investment managers to proposals, both thematically and individually. It also contextualizes the application of investment policies which often contain wide “case by case” flexibility⁸². Asset owners should selectively disclose early proxy votes⁸³, enabling other investors to use that information in determining their own voting rationale (without solicitation concerns)⁸⁴.

7. ERISA plan governance:

The Department of Labor should conduct an industry study of the governance structures of corporate pension plans.

The quality of scheme governance structures is strongly correlated with the quality of scheme outcomes for beneficiaries. International examples suggest that governance structures that are diverse, independent and layered with participant representatives perform best. We note that there are US examples of diversified board structures – in various State Plans and in Taft-Hartley Plans⁸⁵. We note that there have been proposals in the US previously to insert a diversity of stakeholders into scheme governance structures⁸⁶.

Recommendation and next steps:

The Department of Labor should conduct an industry study on ERISA plan governance structures and review the effectiveness, in terms of long-term investment management and beneficiary outcomes, of such structures. Stakeholders are working to identify and publicize the international and domestic evidence on the best performing governance structures for pension schemes.

80 Cost Effective Retrieval of Information by Investors: <https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac-recommendation-data-tagging.pdf>

81 BlackRock Investment Stewardship Guidelines, reports and position papers: <https://www.blackrock.com/corporate/en-br/about-us/investment-stewardship/voting-guidelines-reports-position-papers>

82 SBA Florida - Corporate Governance Annual Summary: <http://www.sbafla.com/fsb/Governance.aspx>

83 CalPERS Global Proxy Voting Decisions: <https://viewpoint.glasslewis.net/GlassLewisWebDisclosure/webdisclosure/search.aspx?glpcustuserid=CAL095&WDFundGroupID=2774>

84 We note such disclosure may be hard to achieve within some asset owner governance structures and that some asset owners prefer to avoid such disclosure on principle.

85 Boards of trustees have equal representation between unions and management

86 Protecting America's Pensions Act 2002 – introduced in the Senate by Edward Kennedy - to balance in 401(k) governance boards

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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