



ICGN

International Corporate Governance Network

Attn: Folarin Akinbami

Law Commission
1st Floor, Tower
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London SW1H 9AG

By Email: fiduciary.duties@lawcommission.gsi.gov.uk

27 January 2014

Dear Commissioners,

Re: Consultation Paper 125 on Fiduciary Duties

The International Corporate Governance Network (ICGN) was founded nearly 20 years ago and is a membership organisation of more than 600 individuals from around the world. Our members represent institutional investors with global assets under management in excess of US\$18 trillion. For more information on the ICGN, please visit www.icgn.org.

We welcome the opportunity to comment on the Law Commission's Consultation regarding application and understanding of fiduciary duties. ICGN's members offer a source of practical knowledge and experience in regard to corporate governance and investment issues that can help inform your fiduciary duty deliberations. In addition, ICGN has adopted statements of principles and best practice guidance that bear on a number of the questions raised in the Consultation Paper. (Copies of the ICGN documents cited in this comment are attached for your reference.) We hope that the Law Commission's final report will take these views into consideration.

Q - 1: Has the Consultation Paper Correctly Stated the Current Law?

We see the Consultation Paper's confirmation that long-term performance, ESG factors and macroeconomic (systemic) factors may be taken into account by fiduciaries as appropriate and important. Verification that, as fiduciaries, trustees should not invest in illegal activities or those which contravene international conventions, regardless of how profitable, also provides welcome guidance for fiduciaries. However, we have concerns about the Consultation Paper's analysis in a number of areas.

The Question Mischaracterises the Issue

We respectfully submit that the question stated by the Commission presents the issue in a way that is unlikely to be helpful for addressing issues that were identified by the Kay Review. We believe that it would be more useful to focus this consultation on how the law is understood and applied by fiduciaries. In fact, the Commission's terms of reference included a request to investigate understanding of the content and application of fiduciary duties, as well as to consider how fiduciary duties are applied in practice. The law is of little practical benefit if it is not implemented appropriately.

"The culture, activities and role of all institutional investors should focus on delivering value to the benefit of beneficiaries or clients over an appropriate time horizon." [ICGN Statement of Principles for Institutional Investor Responsibilities]

Some Assumptions Appear to be Outdated

We are concerned that the Consultation Paper does not consistently and accurately capture present-day institutional fiduciary practices in several important regards. The result is a statement of the law that sometimes appears to address facts which are outdated. Accuracy of assumptions is especially important because risk management and investment practices relating to consideration of systemic (macroeconomic) and environmental, social and governance (ESG) factors have been evolving over the past decade. Given the trajectory of this change, it would be unfortunate if the Commission's final report opined on ethical screening practices of the 1990s without recognising contemporary strategies that integrate systemic and ESG factors into investment and risk analyses.

The following examples of outdated or inconsistent Consultation Paper assumptions illustrate why we are concerned:

- When discussing ESG stewardship, the Commission assumes that only large investors have the capacity to undertake stewardship activities in a cost-effective manner. However, smaller investors have the ability to exercise stewardship by developing proxy voting guidelines for owned shares, engaging external managers that practice stewardship, collaborating with other investors or outsourcing engagement activities to a third party (we note that there are several providers of such services).

"When an investment institution is not of sufficient scale to have governance structures or internal resources such that it is capable of such effective oversight on behalf of beneficiaries or clients, it should consider ways to consolidate, collaborate or build scale such that it is capable of this necessary oversight." [ICGN Statement of Principles for Institutional Investor Responsibilities]

- The Consultation Paper seems to acknowledge, but does little to consider, the impact that climate change, pollution, system financial risks and other externalities generated by practices of portfolio companies have on the analytical and risk management practices of fiduciaries. In particular, resource constraints have become a fundamental reality of the twenty-first century, with major economic consequences for sustainability of company business models and for future retirees.

"Key areas of focus for asset owners which are seeking to align the activities of their fund managers more closely with the long-term interests of their beneficiaries are . . . effectively integrating relevant environmental, social and governance factors into investment decision-making and ongoing management." [ICGN Model Mandate Initiative]

Consistent Application of Time Frames and Risk Horizons

We believe that the Commission's analysis would benefit from greater consistency in application of relevant time horizons. For fiduciaries with inter-generational obligations, achieving balance between short- and long-term perspectives is a critical requirement that should apply across all

aspects of fiduciary duty. The Commission need not resolve exactly how that balance should be struck. However, it should consistently frame the duty of impartiality between interests of different generations as requiring analysis.

"In considering what time horizons are appropriate, institutional investors will need to consider the best interests of their clients and beneficiaries, and any issues of intergenerational fairness between them as well as where the ultimate risk-bearing lies within the institutional investor." [ICGN Statement of Principles for Institutional Investor Responsibilities]

For example, when discussing quality of life factors, we believe the Consultation Paper does not acknowledge sufficiently the importance of time frames. Most fiduciaries have both current and long-term obligations. Trade-offs between considerations such as maximising current returns and contributing to the risk of decreases in future air quality or availability of potable water are a constant challenge for fiduciaries, whether or not they recognise it. The Consultation Paper approaches what it calls quality of life issues in a way that stresses evaluation of only near-term financial returns for two competing investments. It is silent on the cost-of-living effects that can result from pushing pollution costs onto scheme participants who will retire in 30 or 40 years into the future. It also fails to examine implications of trade-offs or generation of (positive and negative) externalities on a portfolio-wide or macroeconomic level.

"The time horizon of most asset owners is considerably longer than that of fund managers. Thus for long-term portfolios, the factors and risks which matter to the asset owner are somewhat different from those typically considered within fund management processes." [ICGN Model Mandate Initiative]

Q - 2: Does the Law Reflect an Appropriate Understanding of Beneficiaries' Best Interests?

Again, we do not see this as a helpful framing of the question in a way that is responsive to the Commission's mandate. The operative question for delivery of investment services which actually serve beneficiaries' best interests should be whether fiduciaries appropriately understand and impartially apply all of their fiduciary duties in the context of current knowledge and circumstances.

In this regard, we think the consultation would benefit from discussion of efforts to engage in two-way communication with beneficiaries regarding their needs, risk tolerances and best interests for a secure retirement. Adequate reporting and disclosure of both investment results and the effects that externalities (i.e., side effects of investment and portfolio company practices) will have on beneficiaries should also be recognised as an aspect of fiduciary duty. This is an area where practices are evolving, and it would be unfortunate if the Commission did not expressly recognise that fiduciaries cannot function effectively without a nuanced understanding of their diverse beneficiaries.

Q - 6: Does the Law Permit a Sufficient Divergence of Strategies?

The Consultation Paper also phrases this inquiry in a way that limits its practical relevance. We agree that the law permits diversity in strategies. The Consultation Paper's observations that trustees are not limited to applying the metrics of Modern Portfolio Theory and that legal advisors often tend toward conservative advice, rather than best practices advice based on impartially serving beneficiaries' best interests, are important findings. However, the final report

should operationalise these findings by providing guidance to fiduciaries for moving beyond such roadblocks. In our view, that was the intent of the mandate which the Commission was given.

Q - 7: Are the Main Pressures towards Short-termism Caused by Fiduciary Duty?

The phrasing of this question appears to confuse the causes of investor short-term herding with the purpose of fiduciary duty. The Consultation Paper appropriately recognises that fiduciary duties are “designed to protect the vulnerable when others have discretionary power to act on their behalf.” This makes fiduciary duty part of the solution rather than part of the problem.

The Consultation Paper also cites the 1985 decision of Sir Robert Megarry in *Cowan v Scargill*, which highlights the obligation of fiduciaries to impartially balance the interests of current and future beneficiaries. This duty of impartiality deserves greater consideration in the Commission's treatment of the tendency of fiduciary investors to herd around similar short-term investment strategies. Divergent intergenerational interests of beneficiaries must be fairly balanced. Part of the remedy for the damage from excessive short-termism which was cited in the Kay Review (and numerous prior studies) is to encourage application of the duty of impartiality, so that processes used by fiduciaries for investment, risk management, monitoring and reporting reflect both short- and long-term considerations.

The law may not create short-termism, but understanding – and application of that understanding – of the law by fiduciaries has certainly been a roadblock to addressing it. Fiduciaries must develop a clearer understanding of the duty of impartiality and be incentivised to apply it. The Commission is in a unique position to help fiduciaries overcome inertia and change long-established patterns of behavior that magnify the risks associated with short-termism.

"Following the financial crisis, there is also an increasing focus on the risk to asset owners of investment approaches which generate systemic risk and the opportunities from those generating systemic benefits. Asset owners are exposed to financial markets generally and so are unlikely to benefit over the long run from investment strategies which produce returns by generating systemic risks that jeopardise the efficient functioning of a particular market or markets more generally. Asset owners thus have an interest in ensuring that their fund managers help to foster well-functioning markets and do not risk undermining them through their investment approach or actions." [ICGN Model Mandate Initiative.]

Q - 20: Is there a Need to Review the Regulation of Investment Consultants?

The ICGN does not have a specific policy on this question. However, we offer advice for asset owners and intermediaries which we think is consistent with their fiduciaries duties. The Commission could, even without regulatory changes, facilitate better management of service provider conflicts of interest by highlighting the obligation of asset owners to identify, minimise and manage conflicts of interest.

"Ultimate owners cannot delegate their underlying fiduciary duties; even when they employ agents to act on their behalf, beneficial owners need to ensure through contracts or by other means that the responsibilities of ownership are appropriately and fully delivered in their interest and on their behalf by those agents, who are to be held to

account for doing so." [ICGN Statement of Principles for Institutional Investor Responsibilities]

Conclusion

We encourage the Commission to produce a plain English report that is useable by fiduciaries and that breaks through the silo presentation of issues in the Consultation Paper, to provide a comprehensive vision of how fiduciary duty should be understood and applied to meet the challenges of the twenty-first century. The complex view of fiduciary duty that was taken by the Consultation Paper will only serve to further confuse fiduciaries, their service providers and their legal advisors. Knitting together an analysis that accords appropriate weight to impartiality, addressing both short- and long-term issues, integration of ESG factors into investment and risk analyses (on a company, portfolio and systemic basis), consideration of externalities generated by portfolio investments and attention to management of conflicts in the service provider chain would go a long way toward updating practical understanding of fiduciary duty so as to be fit for purpose in today's global economy.

We are grateful for the opportunity to comment on the Law Commission's Consultation Paper on Fiduciary Duties. Should you wish to discuss any of the points that we have raised, please feel free to contact Kerrie Waring, ICGN's Managing Director, by email at kerrie.waring@icgn.org or by telephone on +44 (0) 207 612 7079.

Yours faithfully,



Michelle Edkins
Chairman, ICGN Board



Keith Johnson
Member, ICGN Shareholder Responsibilities
Committee

Cc: ICGN Board Members
ICGN Shareholder Responsibilities Committee

To view the ICGN 'Statement of Principles for Institutional Investor Responsibilities' and 'Model Mandate Initiative' please go to: <https://www.icgn.org/best-practice>