

Fiduciary Duties & ESG Integration - where are we today?

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Background

- Growing interest for ESG integration among Institutional Investors /asset owners and consumer
- 10-20 % of European and US invested capital with some form of ESG criteria
- ESG investment practice evolved from “investments based on religious beliefs” to “way of augmenting investment returns” e.g. Richardson (2009:12) *“The SRI sector comprises a diverse array of actors with similarly diverse aspirations and strategies, but it is now dominated by institutional and retail investors whose cues are primarily the financial costs and benefits of acting responsibly.”*
- Challenges within the SRI/ESG market
 - Lack of standard within SRI /ESG industry (e.g. Sandberg et al., 2009)
 - SRI practices tend to allow almost all publicly listed companies (Hawken, 2004).
 - Lack of transparency (e.g. Michelson et al., 2004)
 - Vague (and sometimes misleading) language lead to misperceptions
- Legislators in EU and the US focus on investor protection and restoration of market confidence
 - Quest for legislative cure for asymmetric information and consumer biases (EC, 2007a; EC 2007b; EC, 2007c)

Fiduciary duties in financial markets

Duty to pursue an investment strategy incorporating risk and return objectives suitable to the trust while exercising reasonable care, skill, and caution.

(e.g. Freshfields Bruckhaus Deringer, 2005; Stalebrink O J, Kriz A and Guo W , 2010)

What does this mean?

Fiduciary duties in an investment context contd.

- According to US *modern prudent investor rule* this means that;
 - investments are to be assessed not in isolation but by their portfolio contribution
 - no duty to ‘maximise’ the return on each investment
 - the portfolio must be well **diversified**
 - the prudence of an investment is to be judged at the time the investment was made - not in hindsight. (e.g. Freshfields Bruckhaus Deringer, 2005)

Similar regulation for institutional investors in other jurisdictions

Country	Diversification requirement	Legal duty to...
Australia	Yes	... act prudently* and to act for proper purpose**
Canada	Yes	...act prudently* and to act for proper purpose**
UK	Yes	... act prudently* and to act for proper purpose**
US	Yes, based on Modern Portfolio Theory	... act prudently* and to act for proper purpose**
France	Yes- "adequate spread of risks."	... act prudently and insure profitability by maximizing investment returns
Germany	Risk and liquidity requirements	... manage investments professionally to ensure highest possible security and profitability (sustainable profit)
Italy	Requirements with regard to investment limits and eligible assets	...to act professionally in the interests to obtain the best result given the level of risk
Japan	Profit maximization principle. Screening or other ESG criteria must be used in order to maximize return.	... act in good faith and exercise reasonable care of a hypothetical good manager
Spain	Explicit diversification requirement	...act diligently in the interests of the beneficiaries the and to ensure profitability

Notes: This Table is an adaptation of a "Duties diagram 1: Pensions" in Freshfields Bruckhaus Deringer (2005: 15) complemented with additional information from Berry (2011), Dhaliwal et al. (2010), Freshfields Bruckhaus Deringer (2005), Renneboog et al. (2008a) and UNEP FI (2009).

ESG in this context?

- Two “schools of thought”;

1. “Traditional”; Fiduciary obligations seen as barriers to ESG integration e.g.

‘The duty of prudent investing therefore reinforces the duty of loyalty in forbidding the trustee to invest for any object other than the highest return consistent with the preferred level of portfolio risk... Social factors may be brought in only if it is costless to do so.’ (Langbein & Posner, 1980:98)

2. “Modern”; ESG integration is in fact (or should be) part of fiduciary obligation e.g.

‘It becomes clear that there is a contradiction between a fiduciary being expected to attend to the best interests of owners but only being able to focus on narrow traditional financial return criteria.’ (Joly, 1999:295)

Renowned court cases

- US
 - Bd. of Trustees v Mayor of Baltimore City, 317 Md. 72, 562 A.2d 720 (1989).
 - A trustee has no obligation maximize returns, but to secure a 'reasonable' return without unnecessary risk.
 - UK
 - Cowan v. Scargill
 - The purpose of a trust is to provide financial benefits
 - Harries v. Church Commissioners [1992]
 - A portfolio screening out 37 per cent, by value, of all listed United Kingdom companies, including 65 per cent of the oil sector and 62 per cent of the chemical sector was not prudent.
 - However, no problems with charitable trust negatively screening investments conflicting with the purposes of the trust.
- At least the UK court cases are up for re-interpretation e.g. Freshfields Bruckhaus Deringer, 2005:8:

“The position in the UK has been coloured by the misunderstood decision of Cowan v Scargill.”

Still unclear? Other “rules of thumb”

UK - “tie break principle”

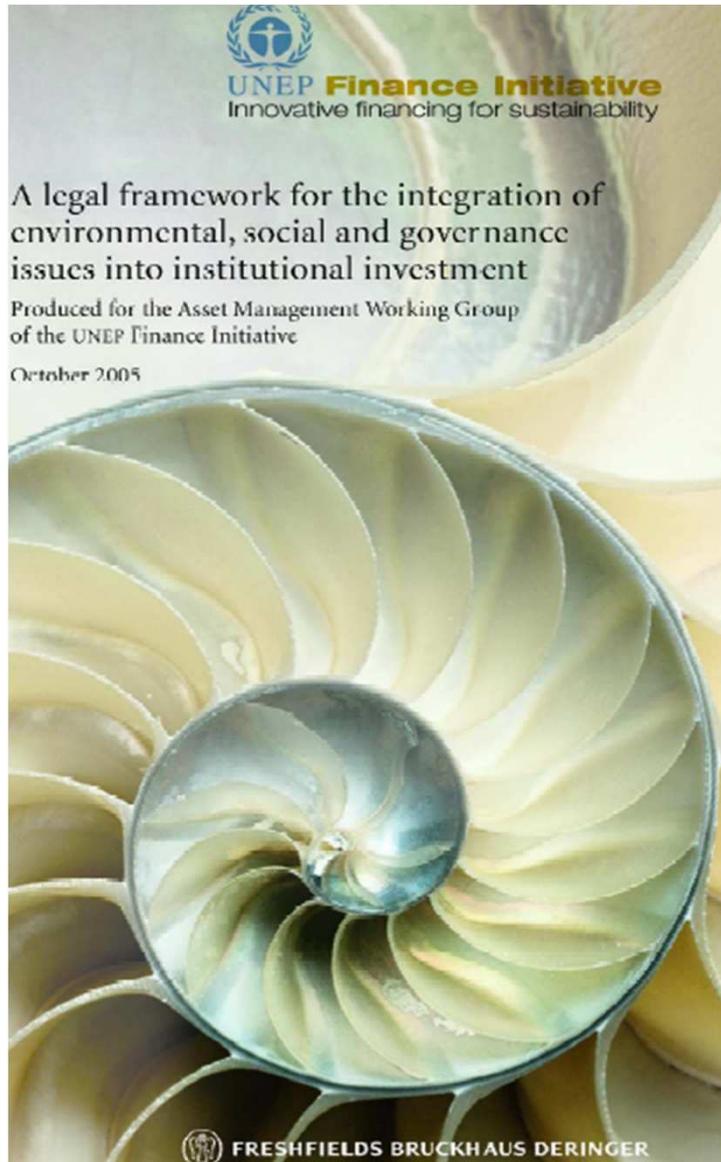
As far as possible, when you decide on the investment strategy for the scheme, you should put aside your personal views on the ethical aspects of particular investments and get the best financial return that is achievable at the desired level of security or risk.

However, you can consider non-financial matters when comparing investments with the same potential return. So, you can choose a particular investment which you find more attractive for ethical reasons, as long as the ethical investment is likely to perform as well as, or better than, the non-ethical investment.’
(The Pension Regulator 2002)

Australia – “sole purpose test”

‘[...] the sole purpose of a superannuation fund is to provide monetary retirement benefits to its members’ (Taylor & Donald, 2007:2)

Clarification needed – the Freshfields report



Question

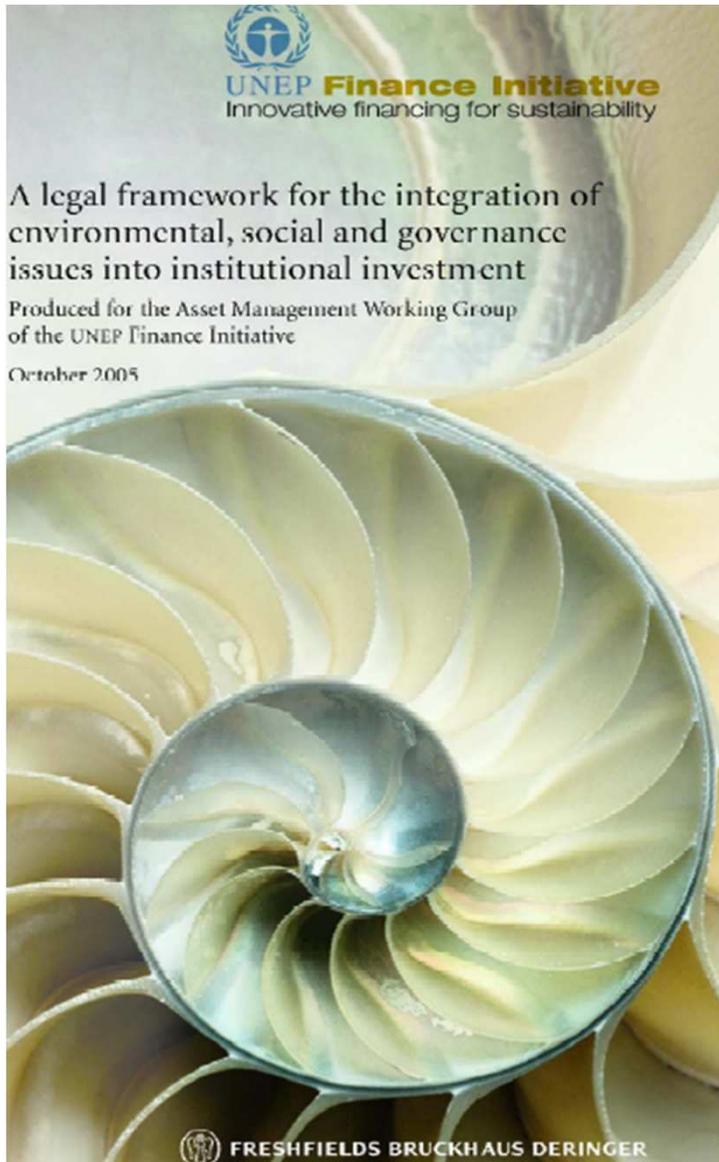
'Is the integration of environmental, social and governance issues into investment policy (including asset allocation, portfolio construction and stock-picking or bond-picking) voluntarily permitted, legally required or hampered by law and regulation...' (Freshfields Bruckhaus Deringer, 2005:6)

Answer

'...integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions.'* (Freshfields Bruckhaus Deringer, 2005:13)

*Australia, Canada, France, Germany, Italy, Japan, Spain, United Kingdom, United States.

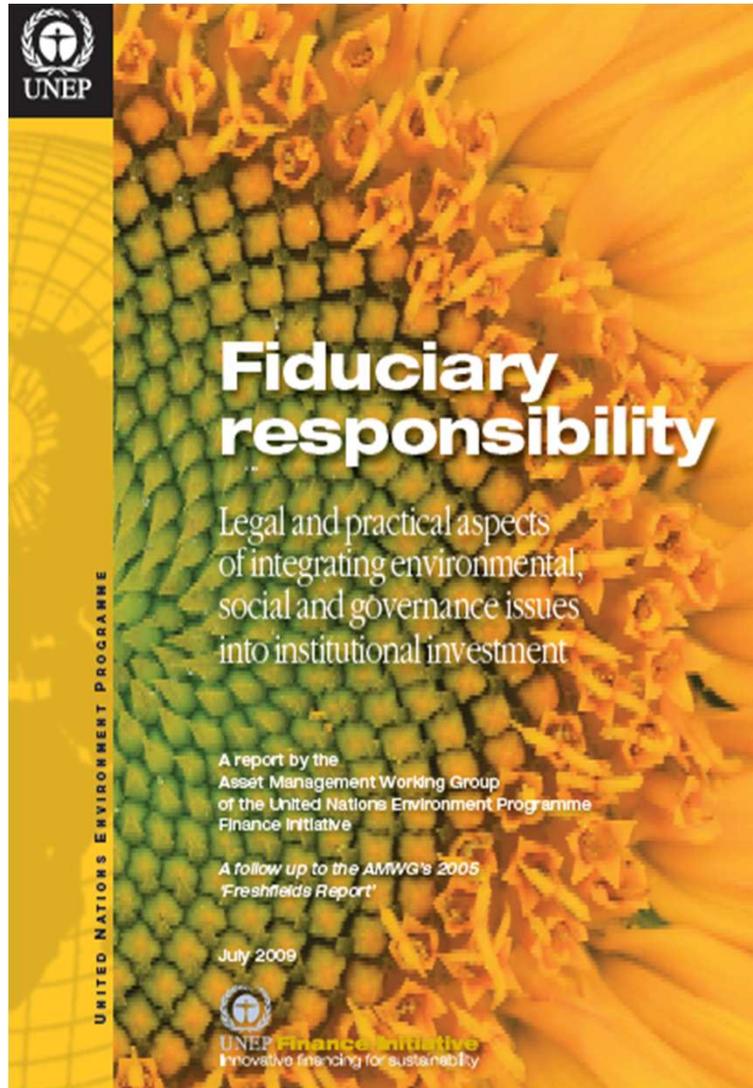
Clarification needed – the Freshfields report



Still;

“Despite the growing body of evidence that ESG issues can have a material impact on the financial performance of securities and an increased recognition of the importance of assessing ESG-related risks, those seeking a greater regard for ESG issues in investment decision-making often encounter resistance on the basis of a belief that institutional principals and their agents are legally prevented from taking account of such issues’ (Freshfields Bruckhaus Deringer, 2005:6)

Clarification needed – the Freshfields follow up report



“ In the four years since the launch of the original Freshfields Report by the AMWG, we have seen more innovation and evolution in the field of ESG integration than in any other similar time span in history...

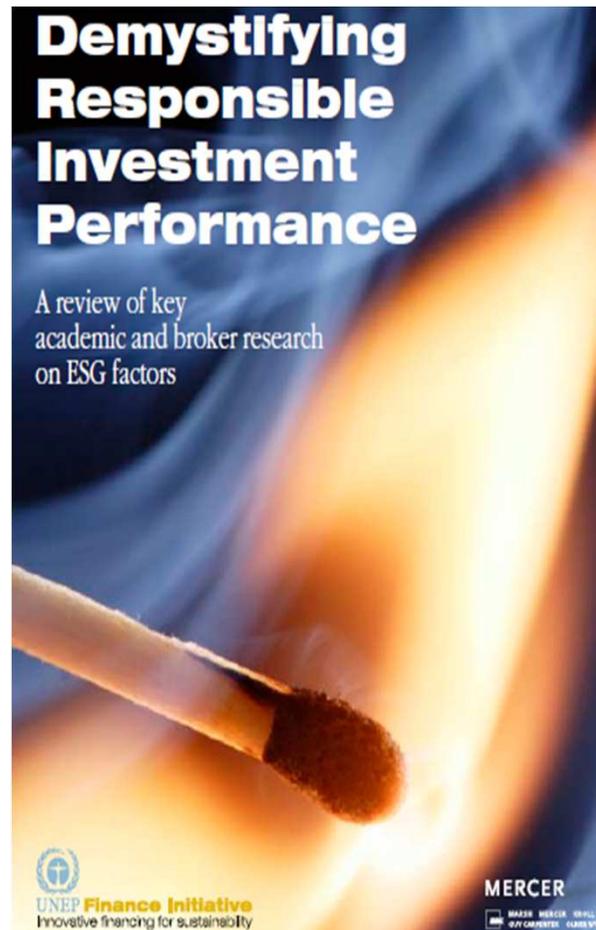
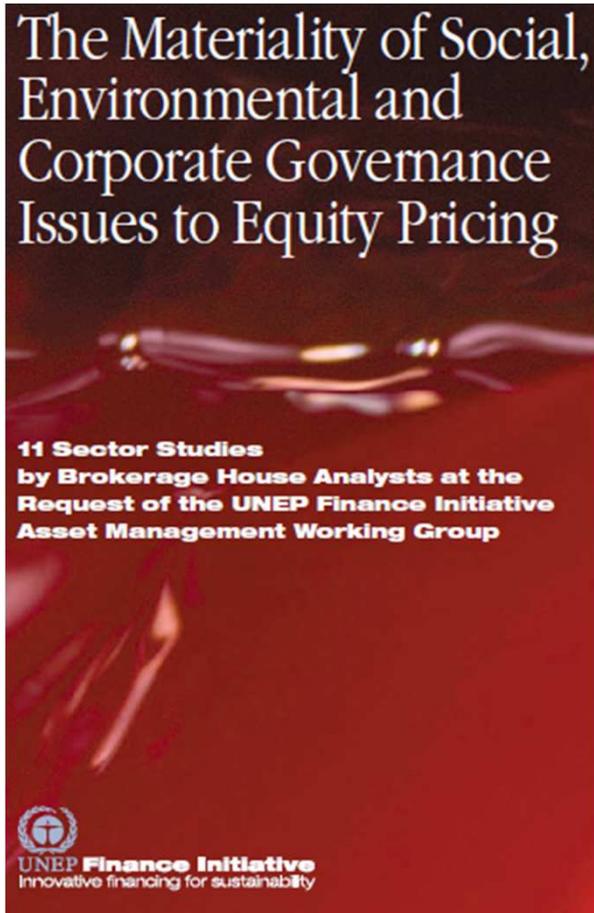
Clearly, much progress has been made since the publication of the Freshfields Report, but the AMWG believes even more can and must be done...

For this reason, this latest AMWG report, termed ‘Fiduciary II’, serves as a sequel to the Freshfields Report by providing a legal roadmap for fiduciaries looking for concrete steps to operationalise their commitment to responsible investment. (UNEP FI: 2009:14)

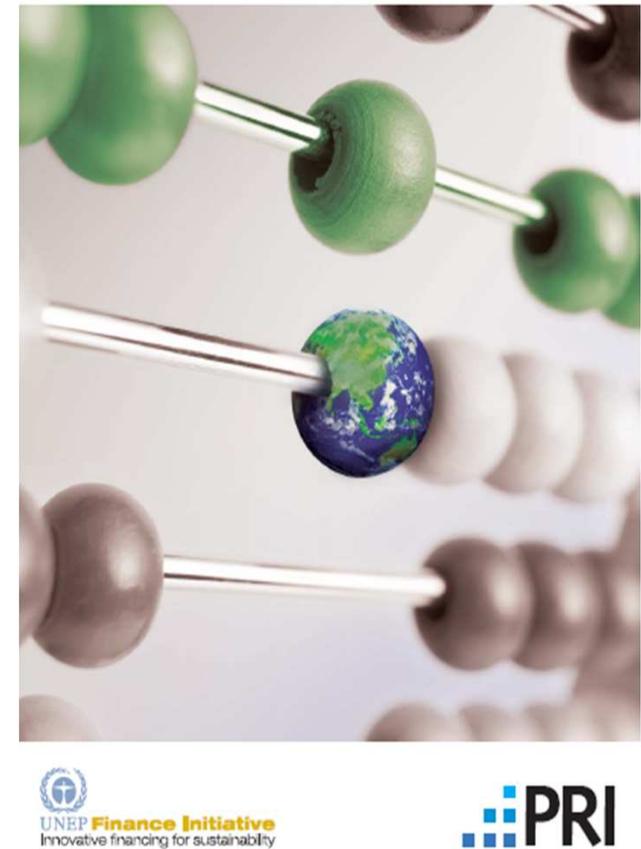
SIRP

Sustainable Investment
Research Platform

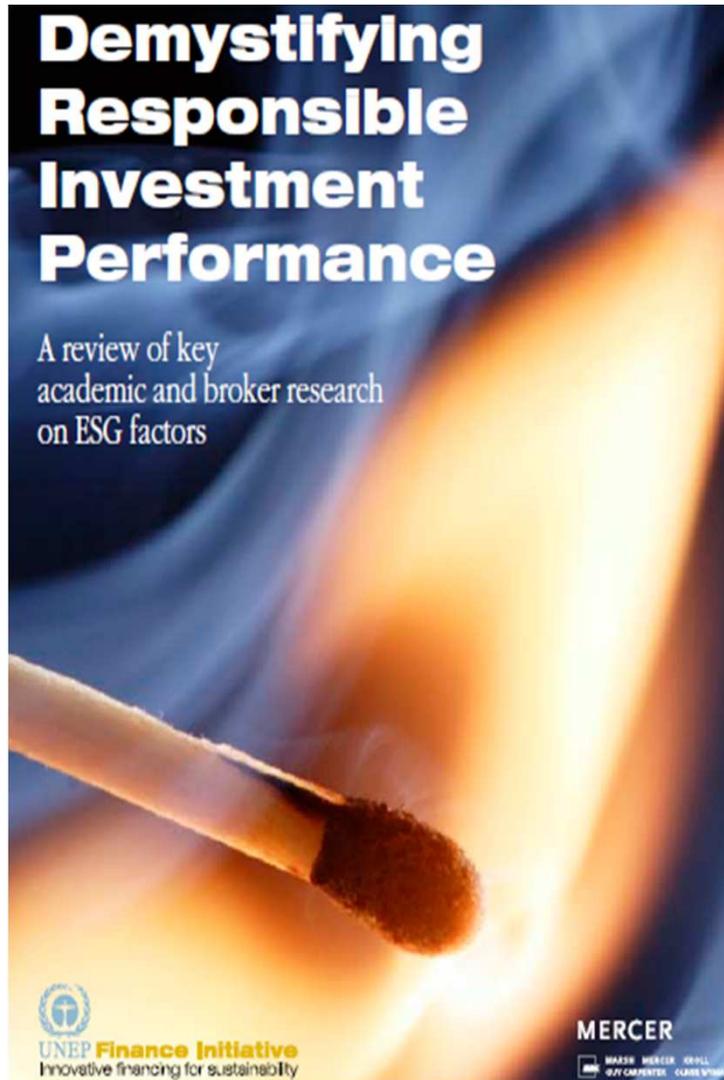
The quest for a link between ESG performance and financial performance



Universal Ownership
Why environmental externalities matter to institutional investors



E.g. the UNEP FI & Mercer 2007 report



'There has long been a debate between those who regard environmental, social and governance(ESG) factors as being risk factors which can have a material impact on investment performance and those who regard them as exclusive social issues...

Over time, as more resources are allocated to research in this field and data comparability improves, we anticipate that the evidence supporting ESG integration will become more robust.' (UNEP FI & Mercer 2007; 6)

Conclusions

- Conceptual confusion persist
 - How does fiduciary duties relate to ESG integration
 - “what needs to be done in order to properly adapt ESG integration”?

Conflict between fiduciary duties and ESG integration if

- ESG integration motivated by personal biases (must be economically motivated)
- If ESG integration obviously adversely affects portfolio risk and return (e.g. negative screens disqualifying asset classes or regions completely)
- Most (all?) institutional investors (asset owners) are not social crusaders
- Reason to focus on link between ESG and portfolio performance to boost the acceptance of ESG integration
 - Fiduciary duties still seen as hindrance to ESG integration among practitioners – bad excuse or lack of interest?