January 2014
By email: Fiduciary.duties@lawcommission.gsi.gov.uk

Response to Law Commission: Fiduciary Duties of Investment Intermediaries

About Aviva Investors

As a founding signatory to the UN Principles for Responsible Investment (PRI), we believe that companies conducting their business in a sustainable and responsible manner are more likely to succeed over time. Our dedicated Global Responsible Investment (GRI) team works with fund managers and analysts globally and across all asset classes to integrate environmental, social and corporate governance (ESG) issues into our investment decision-making and analysis to deliver long-term shareholder value for our clients. Over twenty years, we have developed a deep understanding of the conflicts, barriers and challenges to good governance. We believe such experience and insight are crucial in identifying and addressing risks and opportunities within our clients' portfolios.

We have a strong commitment to international standards and principles of good governance such as the UK Stewardship Code and International Corporate Governance Network (ICGN) Global Corporate Governance Principles. We are signatories to the UN Global Compact and formally recognise international standards such as the OECD Guidelines for Multinational Enterprises, the Universal Declaration of Human Rights and the International Labour Organisation core labour standards.

Introduction

Aviva Investors welcomes the opportunity to respond to this latest consultation on Fiduciary Duties of Investment Intermediaries by the Law Commission, prompted by the Kay Review of UK Equity Markets and Long-term Decision Making ("the Kay Review").

Our full response to the Kay review can be found here:
http://www.avivainvestors.co.uk/internet/groups/internet/documents/salessupportmaterial/pdf_027396.pdf

We believe that Professor Kay produced a thorough and thoughtful analysis of the causes of short-termism in the equity markets. However, we believe that the report failed to fully examine the role of all participants in the investment chain that can significantly influence the way investment is allocated by asset owners and ultimately the way companies are structured and develop their strategies.

Both Professor Kay and the Secretary of State have made several welcome proposals, for example on narrative reporting, ending quarterly reporting and the establishment of a new investment forum to reinvigorate collective engagement. We welcome these proposals as they fit with our investment beliefs, which are centred on being long-term, engaged, active investors running low turnover, focused portfolios.

However, by failing to provide recommendations that address all the participants that influence the investment chain, or its inherent tensions and commercial conflicts, neither the review nor the government's response sufficiently address the underlying causes of short-termism in the market. For example, it misses the opportunity to encourage investment consultants to oversee the way asset owners and their managers engage in stewardship and to examine the significant role played by sell-side brokers.

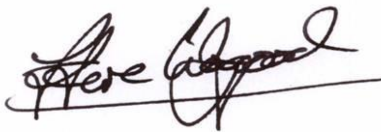
We believe fiduciary duties are only one part of the wide range of policy, legislative and cultural changes that are needed to ensure that capital market players are sufficiently incentivised to behave in the interests of the long-term and the capital markers promote, rather than undermine, sustainable economic development. While the interpretation of investing in beneficiaries' best interests is not the only driver behind the shift towards short-termism, it does play a meaningful part.

Additional background

We have contributed to and commend to you the consultation responses of the UKSIF and Shareaction on this topic. Finally the UNEPFI[1] Fiduciary Responsibility report, widely known as "Freshfields II", is considered to be a pertinent external underpin to our stance on the topic of fiduciary duty and we commend it to you.

If you have any questions in relation to this response or would like further clarification please do not hesitate to contact us at gri@avivainvestors.com

Yours sincerely,



Steve Waygood
Chief Responsible Investment Officer
Aviva Investors

[1] UNEP, FI, and Asset Management Working Group. "Fiduciary responsibility: Legal and practical aspects of integrating environmental, social and governance issues into institutional investment." *UNEP FI: Geneva* (2009).

Key issues and concerns

We agree with the premise of the Kay Review recommendation to the Law Commission to review fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers. In particular, we are concerned that:

- There is lack of clarity with regard to who is subject to fiduciary duties and what those duties are;
- Investment consultants are not subject to fiduciary duties;
- The common interpretation of fiduciary duties focuses on short-term company performance rather than considering long-term strategy;
- Stewardship activities are frequently omitted from Investment Management Agreements

The need for clarity

There is no dispute that pension fund trustees have fiduciary duties to their beneficiaries. In parallel to this we also consider that discretionary asset managers, consultants and other investment advisors have fiduciary duties to their clients. However, there is a gap in the awareness of the duty and the understanding of how this duty should be discharged and monitored.

Lack of clarity regarding who should take responsibility for fiduciary duties in the investment chain is a key cause for the current confusion. Pension funds have a fiduciary duty to scheme members, while asset managers owe a duty to the end investors, and directors of quoted companies have a fiduciary duty to shareholders. Drawing upon our experience in this arena and anecdotal evidence we believe, in the round, fund managers are reluctant to say if they have a fiduciary duty and pension fund trustees rarely consider during the manager selection process whether their asset managers accept that they too have fiduciary duties. Consequently Investment Management Agreements ("IMAs") that bind both parties exist that do not address fiduciary duty in any meaningful way and add to the general level of confusion in this area. We believe this should be addressed. We would like to take this opportunity to draw your attention to the Freshfields II sample investment objective provision on page 30.

We strongly believe that clarification of the specifics of fiduciary duty would be helpful for all parties along the chain of responsibility.

The role of investment consultants

It would appear that the concept of consultants having fiduciary duties is not generally accepted. This is pertinent because there is significant scope for conflicts of interest to arise in the dispensing of investment advice. Furthermore, many asset owners with limited or no in-house expertise rely heavily on investment consultants. One example would be the potential for advice to skew towards the more complex products, as this acts as a perpetuating catalyst for more advice. However, the costs associated with these more complex strategies may not be justified by better outcomes for beneficiaries. In addition to this, consultants tend to charge a fixed hourly rate and therefore have an incentive to be active in order to maximise their income. They therefore offer an increasingly wide range of services that they encourage trustees to use, opening the door to further conflicts. In tandem, income generation stems significantly, but not exclusively, from the fund manager selection process, so consultants may be perversely incentivised to encourage fund manager churn.

The degree to which consultants take into account factors relating to the long-term sustainability of companies is dependent on: the degree to which pension fund trustees wish to take them into account; the cost of maintaining dedicated research teams and

the lack of good long-term comparable data. While there are some good examples of investment consultants integrating long-term factors into their analysis, there is a significant contingent that do not.

Although accountability and responsibility ultimately sits with trustees we would welcome further review of whether and how investment consultants could be regulated to ensure conflicts of interests are mitigated and they act in the best interests of the client and the underlying beneficiary.

We strongly believe that clarification of the fiduciary duty as it pertains to consultants would be helpful for all parties along the chain of responsibility.

Focus on long-term factors

We believe a well-managed, responsible business will perform better and create more sustainable value over the long term. Goldman Sachs analysis has indicated that there is direct correlation between sustainable business practices and the longer-term financial success of a company in a number of sectors.
However, where their discretion to consider environmental, social and governance (“ESG”) issues is not made explicit in the trust deed, statement of investor principles or the IMA, it is common for institutional investors to default to the interpretation of their fiduciary duties which requires them to focus solely on maximising profit for the beneficiaries in the short term, and actually prevents them from considering ESG factors in their decision-making (Richardson, 2008; UNEP FI, 2005). The original Freshfields Report and the update argued that institutional investors’ reluctance to consider ESG impacts is misplaced.

Consideration of long-term factors, such as the risks or opportunities arising from environmental, social and governance issues, can therefore enhance investment decision-making. However, this requires widespread reporting on these areas by companies, in accordance with a consistent framework and standards. Currently, of 20,000 publicly listed companies globally that were reviewed through Bloomberg’s database, less than one in five publicly reported on even a single item of quantitative data on environmental, social or governance issues.[2]

By measuring and disclosing governance, environmental and social information, companies can better understand, evaluate and eventually manage their risks- a necessary step towards building sustainable business models around the concept of ‘shared value’. Furthermore, investors are able to allocate capital in a more sustainable way, civil society can engage in constructive dialogue and effective partnership with the private sector, and governments can enable a better level of national sustainable development policy making and programme delivery based on actual information of corporate practices and aspirations on the key dimensions of sustainable development.

We would issue a warning of caution that the Law Commission should avoid falling into the trap of allowing ethical issues to be grouped as a class of factors and dismissed simply because they have been labelled ‘ethical’.

The importance of IMAs

Despite pockets of good practice, currently, market demand for good stewardship and the integration of governance issues into investment is of relatively low quality, due in part to a misunderstanding of fiduciary duties.

We strongly believe that clarification of fiduciary duty and stewardship responsibilities within the Investment Management Agreements would be helpful for all parties along the

[2] http://www.guardian.co.uk/sustainable-business/aviva-chief-city-failure-sustainability

chain of responsibility, ideally in the form of a good practice code/guidelines drawing upon the learnings from Freshfields II.

Our recommendations

We have reservations about how the law is interpreted in practice, but we do not think the law itself requires material statutory overhaul. Instead, we offer a number of recommendations to address the concerns highlighted.

1. The Law Commission should issue a **final statement of clarification** outlining the meaning of fiduciary duty. We would suggest that the statement of clarification is written in accessible and non-legal language that is a candidate for the Crystal Mark from the Plain English Campaign so that it can be widely cited and distributed to non-technical trustees and pension fund beneficiaries.

2. The Law Commission to recommend **good practice guidance** with regard to integrating ESG issues into investment decision making. This may also be drafted by or in conjunction with the Financial Conduct Authority. The guidance should be permissive and encourage trustees to consider systemic issues and ESG risks and have due regard to the impact on society as a whole while maintaining its focus on purpose of the trust (i.e. delivering pensions). It should permit trustees to consider whether ESG factors may have a long-term impact on the fund. Intergenerational concerns should be also be explicitly addressed, and we recommend that the guidance highlights the need for trustees to balance short-term financial pressures with a prudent consideration of longer-term and systemic issues.

3. The Law Commission to recommend a **duty of care on investment consultants** to proactively raise these issues in an advisory environment. Quayle Watchman Consulting, in Freshfields II, goes on to clarify that institutional investment consultants and asset managers have a professional duty of care to *proactively* raise ESG considerations with their clients.

4. The Law Commission to develop good practice code/guidelines for the **Investment Management Association's model mandate** drawing upon the learnings from Freshfields II.

Our response to specific consultation questions

We have responded to those questions where we believe we have the most to add. If you have any questions in relation to this response or would like further clarification please do not hesitate to contact us.

Question 1: Do consultees agree that Chapter 10 represents a correct statement of the current law?
Our principal concern in relation to this consultation is not how fiduciary duty is currently defined in law, but how the law is interpreted in practice. We think this misapplication of the law is a significant issue which needs to be addressed by the Law Commission. We strongly believe environmental, social and governance (ESG) considerations are part of the broader context of fiduciary duty. Consequently, an investment strategy that aims to choose the best-performing securities based on both financial and ESG criteria is a prudent strategy that takes advantage of the fact that markets are not always efficient at pricing ESG risks. This point was recognised in a recent presentation by the Law Commission presentation[3], which mentioned that "*ESG can make companies well run and more sustainable and this could lead to better long-term returns*" (slide 7) and this can be described as good investment practice. As trustees "*may not fail to consider the best interests of beneficiaries*" (slide 8), we believe it would be helpful to be clear to Trustees what actions that they could take in relation to ESG.

Question 2: Do consultees agree that the law reflects an appropriate understanding of beneficiaries' best interests?
We do not agree with the Law Commission interpretation of the beneficiaries' best interest in so far as we are able to understand the scope of "best interests". Given the findings and recommendations of the Kay Review we are surprised that the review has such a limited focus on the long-term. In our view, the Law Commission has not sufficiently addressed the issue of intergenerational equity in the consultation and as a result, a thorough understanding of beneficiaries' best interests as a whole remains wanting.

We disagree with the Law Commission's statement: "*We think it may be helpful for trustees to be able to quote the law of fiduciary duties to resist pressures to act in ways which would reduce the benefits available to members*" (Page 10 paragraph 14.). While we are in agreement that trustees have a primary duty to the beneficiaries, we do not believe the primary purpose of fiduciary duty is to provide a tool for trustees to resist pressures for change, thereby maintaining the status-quo. Status quo thinking may not always provide a full understanding or appreciation of emerging risks and opportunities and the impact that those risks may have on the retirement benefits available to current or future members. Therefore views and ideas that challenge the status-quo are fundamental to ensuring investments are regularly reviewed and evaluated according to changing external factors that might affect members' benefits or the short and long-term value of the fund. The strategy advocated by the Law Commission here appears to replicate the current problem, which is that fiduciary duty (although clear in law) is often used in practice to justify inaction by trustees based on erroneous advice that draws a false distinction between ESG/long-term factors and the value derived from members by the investment strategy.

Question 3: Do consultees think that the law is sufficiently certain?
No, we do not feel the law is sufficiently clear in this area. Furthermore, the Law Commission does not take a view on what time-frame decision makers should apply a judgment of financial return in order to determine if an action "would reduce the benefits available to members". Trustees must balance the long-term needs of future

[3] Law Commission Presentation on Fiduciary Duties Consultation Paper – Roundtable events – 9th January 2014 at Hogan Lovells, London

beneficiaries with the more imminent obligation to current pensioners – one should not jeopardise the other. It may be incorrect to assume reduced benefits to members in the short-term will produce sub-optimal results overall. Arguably, it would be considered imprudent for a trustee to favour the interests of older beneficiaries in the short-term over those beneficiaries not expected to retire for another 20 or 30 years, or vice-versa.

Question 5: Are there any specific areas where the law would benefit from statutory clarification?

Yes, we believe that further clarification is required to provide guidance to practitioners on how the law of fiduciary duty should be interpreted in practice. In doing so, the Law Commission should start from a position that the law of fiduciary duty should act as an enabling tool for trustees and not a tool for trustees to use to "resist pressures to act". Permissive statements such as "trustees may consider…" will go a long way to eroding the myths that continue to dominate current practice. We do not think sending the message to trustees that the law of fiduciary duty is intended to assist in resisting pressure to change is appropriate or correct.

Question 6: Do consultees agree that the law permits a sufficient diversity of strategies?

We agree that the law permits a sufficient diversity of investment strategies. However, to move away from Professor Kay's "herd mentality" the investment industry must rein in the focus on price-based returns and understand the long-term implication of today's financial decisions. We have become an industry of short term price takers as opposed to long=term value makers. Sustainable economic development requires reversing these poles.

Many asset owners with limited or no in-house expertise rely heavily on investment consultants. This reliance on investment consultants can result in trustees applying the law narrowly, assuming that they must maximise short-term financial returns to avoid litigation, regardless of other factors that may be relevant to the mandate such as ESG issues, systematic risks, or macroeconomic trends.

Question 7: Do consultees agree that the main pressures towards short-termism are not caused by the duty to invest in beneficiaries' best interests?

We do not agree. While the interpretation of investing in beneficiaries' best interests is not the only driver behind the shift towards short termism, it does play a meaningful part. We see the quarterly reporting regime as detrimental to long termism, amongst other drivers. We believe trustees may be reluctant to publically air views regarding the lack of clarity about the implications of fiduciary duties due to fears of first mover criticism, if not worse penalties. This is likely to impact the responses received.

During the passage of the Pensions Bill in 2008, the government was pressed in both Houses of Parliament to take the opportunity presented by the Pensions Bill to bring in legislation to clarify the fiduciary duties of pension fund trustees; in particular, whether pension fund trustees were prohibited by their fiduciary duties from considering social and moral criteria in their investment decision-making.

While it was put on the record that there was no inconsistency in taking such criteria in account with the fiduciary duties of pension trustees; unfortunately, given equally difficult and important questions arise in respect of the clarity the fiduciary duties of pension fund trustees, the government declined to introduce amending legislation to clarify the position of pension fund trustees. While this lack of clarity remains, it may present an unhelpful and unnecessary blockage and complication to the ultimate detriment of beneficiaries.

Question 8: Do consultees agree that the law is right to allow trustees to consider ethical issues only in limited circumstances?

We disagree. We consider the tone of the narrative to be outmoded and overly negative. We would also caution the Law Commission against falling into the trap of allowing ethical issues to be grouped as a class of factors and dismissed simply because they have been labelled 'ethical'. As we have seen in well-respected reports, such as the Stern Review on the Economics of Climate Change which demonstrates clearly the financial impacts of long-term factors such as climate change, it would not be prudent to ignore such factors without consideration.

We note that the definition of ESG in the Law Comission's glossary is at odds with the generally accepted definition by the investment industry. It is widely accepted that ESG stands for environmental, social and governance rather than the Law Commission's definition of ethical, social and governance. Secondly, we are keen to emphasise that ESG has developed over the last two decades to much more than simply stock screening. Labels such as ethical, ESG, systemic, macroeconomic etc. are shorthand for areas of knowledge and should not grant any trustee permission to ignore those factors.

Furthermore, the statement "*We see advantages to legal rules which remind trustees that their duty is to provide pensions and not to improve the world in some general sense, possibly at the expense of their beneficiaries*" (para 14.28) is unhelpful at best.

It reinforces the view that investment decisions can and should be made in a vacuum and that capital markets are somehow entirely disconnected to megatrends such as climate change and incur no impact on society and the economy. We consider this an antiquated view and, in a broader sense, it appears to contradicts the Companies Act 2006 which requires directors to have due regard to social, economic and ethical issues, and to consider the company's impact on communities, the environment, and society as a whole.

There is no shortage of readily available examples of why ethical issues can be financially relevant, not least, the unethical behaviour in the UK's banking sector which has lead to a material negative financial impact as a result of the financial crisis, government fines, investigations and greater banking regulation. The classification of these issues as ethical by some market commentators should not discount their value or relevance to an investment decision on whether or not to hold the stock. However, we are conscious that we cannot apply a blanket assumption that ethical issues are always financial and many instances of malpractice go unpunished by the capital markets. The crux of the matter is that fiduciary duty implies and requires the demonstration of skill, care and judgement when determining those situations involve ethical issues that have a financial impact.

Question 10: Does the law encourage trustees to achieve the right balance of risk and return?

We believe the law is often interpreted in a way that defines risk very narrowly. It therefore does not give adequate treatment to systemic and ESG risks that may at first be viewed as non-material, but that have financial impacts over time. We note that "risk" as quoted in para 14.29 is interpreted in the document to mean volatility risk. We believe the Law Commission should issue a statement of clarification that highlights the fact that the law is permissive in allowing trustees to consider a broader interpretation of risk and return that includes ESG and systemic factors.

Question 11: Are there any systemic areas of trustees' investment strategies which pose undue risks?

Yes. Capital markets are phenomenally important to society. The invisible hand of the market guides the production and distribution of the goods and services that we collectively enjoy. In order to help inform our views in this area, in 2011 we commissioned Forum for the Future to produce "Vision 2040 – A Framework for a Sustainable Economy". Forum for the Future's work has had important implications for our views. Their research highlighted that we are approaching a number of environmental boundaries (such as concentrations of greenhouse gases and availability of water and land). Such is the systemic nature of these sustainability challenges that the implications will affect every member and every sector. Looking at the timescales for defined benefit schemes operate, these issues are likely to come home to roost. They are even more pertinent on a defined contribution timescale.

Question 12: Overall, do consultees think that the legal obligations on trustees are conductive to investment strategies in the best interests of the ultimate beneficiaries?
And Question 13: If not, what specifically needs to be changed?

The law is sufficiently clear that trustees must invest in the best interests of the ultimate beneficiaries. At the present time the law does appear to place the obligation on trustees to factor in long-term considerations such as sustainability. However, for a myriad of reasons discussed in this response, the letter of the law is not being followed and the majority of trustees are given insufficient attention to this highly pertinent topic. One practical step forward would be to ensure consultants and professional trustees are subject to sufficient capacity building while, in parallel, made aware of their fiduciary duties in this arena.

We do not consider it prudent to separate the concept of beneficiaries' best interests from the best interests of society and the economy as a whole, as we believe these factors are inextricably linked. The separation in the Law Commission narrative is artificial. We also think there is some merit in ensuring the law of fiduciary duty is consistent with the Companies Act 2006, which requires directors to have due regard to the impact of the company on communities and society as a whole.

Equally, it is also implicit in this consultation that 'best interests' often equates only to the 'best short-term financial interests' of the beneficiaries. While there is credence to the argument that the fund must make money in the short-term in order to continue to exist in the long-term, there is a risk that this philosophy may lead to over-focus on the short term. We would welcome statements from the Law Commission that emphasise the need for trustees to consider intergenerational equity in their deliberations.

Question 14: Do consultees agree that the duties on contract-based pension providers to act in the interests of scheme members should be clarified and strengthened?

Yes.

Question 15: Should specific duties be placed on pension providers to review the suitability of investment strategies over time? If so, how often should these reviews take place?

Yes, we believe it would be valuable for pension providers to periodically review the suitability of the investment strategy, particularly for contract-based pension providers. The investment principles may become outdated over time and may not serve the best interests of the beneficiary. A requirement to review the strategy every five years would be sufficient, in our view. Reviews on a more frequent basis may be costly for the funds, particularly smaller funds.

Question 18: Do consultees agree that the general law of fiduciary duties should not be reformed by statute?

At present, we have concerns that the law is not understood in practice and may be interpreted too narrowly to facilitate long-term investing and meaningful stewardship strategies but are unable to say which is the most preferable route to address this (e.g. case law, regulatory change as pertains to Trust Deeds, SIPs and IMAs, or a statutory intervention). However, as highlighted in our recommendations, we strongly urge the Law Commission to issue a statement of clarification to assist trustees and their advisors in interpreting the law of fiduciary duty.

Question 20: Is there a need to review the regulation of investment consultants?

Yes, we suggest, given the pivotal role of investment consultants, that they are also subject to fiduciary duty. Anecdotal evidence suggestions trustee boards comprised of laypersons often lack the skills and experience to critically evaluate and challenge the advice of consultants and often treat them as a layer of indemnity. Although accountability and responsibility ultimately sits with trustees we would welcome further review of whether and how investment consultants could be regulated to ensure conflicts of interests are mitigated and they act in the best interests of the client and the underlying beneficiary.