

FINANCIAL CONDUCT AUTHORITY

ASSET MANAGEMENT MARKET STUDY

ABOUT THE PRI

The United Nations-supported Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI has over 1600 signatories globally with \$62 trillion in assets under management, 230 of whom are in the UK – 47 asset owners, 170 asset managers and 12 investment consulting firms.

Responsible investment is an approach to investment that explicitly acknowledges the relevance to the investor of environmental, social and governance (ESG) factors, and the long-term health and stability of the market as a whole. It recognises that generating long-term sustainable returns is dependent on stable, well-functioning and well governed social, environmental and economic systems.

The PRI is undertaking a number of work streams that are highly relevant to the FCA's study. In January 2016, the Principles for Responsible Investment (PRI), the United Nations Environment Programme Finance Initiative (UNEP FI) and The Generation Foundation launched a three-year project to clarify [investor obligations and duties](#) in relation to the integration of environmental, social and governance (ESG) issues in investment practice. This includes a detailed review of investor duties in our [UK Fiduciary Duty Roadmap](#) and makes a number of recommendations on regulatory action and investment practice.

Our [Sustainable Financial System \(SFS\) programme](#) looks to address the risk and challenges that undermine financial system sustainability by putting in place a series of steps that will lead to change – with a particular focus on institutional investors and the intermediated investment chain. We have identified the influence of advisors and consultants as an important area to address. They occupy key privileged position in the market and exert important influences on the manner in which institutional investors invest.

SUMMARY OF PRI'S POSITION

We strongly support the FCA's Asset Management Market Study. It is an important intervention in the UK capital market that addresses a number of challenging and complex issues and we welcome the opportunity to provide feedback. We are pleased to see the interim findings closely track the PRI's recommendations in our UK Fiduciary Roadmap. In particular, we recommend that:

1. The FCA extent the market study to include ESG issues

2. Clarification of the duties asset managers owe to their clients and end investors
3. AFM comparability on costs, portfolio turnover, research and stewardship
4. FCA assumes responsibility from HM Treasury on the role of investment consultants and advice given to AFMs.

Regarding the scope of the study, we consider that the FCA's study is too narrow in its coverage of environmental, social and governance issues and fails to directly address ESG issues as a potential driver of competition and a growing unmet investment industry need. As the study points out, a sample of 34 Investment Association members, half reported that they managed at least some proportion of assets according to ESG considerations and, where they did, approximately one fifth of total assets were subject to ESG requirements.

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 returns.¹ ESG factors have been an essential part of long-term fundamental investment management processes for many years – without the use of the label “ESG”. Management of ESG factors can also be a source of enhanced operational performance and financial prospects in investee companies.²

Given the significant investment risk from un-assessed ESG issues, we would expect the FCA to expand its coverage of ESG in the final report.³ Climate risk is one particular example. The European Systemic Risk Board estimates that EU financial institutions have significant direct exposure to fossil-fuel firms over €1 trillion and estimates potential losses of between €350 billion and €400 billion, even under an orderly transition scenario.⁴

The remainder of our response covers recommendations 2-4 are covered in more detail.

CONTACT

The PRI has experience in international ESG regulation and has developed a wealth of practical guidance on incorporating ESG factors into investment decision making. We would welcome further dialogue on the issues raised in this paper. For further information, please contact Morgan Slebos, Senior Policy Analyst (morgan.slebos@unpri.org).

1 SBA Florida, Valuing the Vote: [tps://www.sbafla.com/fsb/Portals/Internet/CorpGov/ReportsPublications/SBAValuingtheVote2015.pdf](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>

2 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

3 MIT Sloan Manager Review, Investing For a Sustainable Future: <http://sloanreview.mit.edu/projects/investing-for-a-sustainable-future/>

4 European Systemic Risk Board, Too late, too sudden: Transition to a low-carbon economy and systemic risk: https://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_6_1602.pdf

SPECIFIC FEEDBACK

A STRENGTHENED DUTY ON ASSET MANAGERS TO ACT IN THE BEST INTERESTS OF INVESTORS

What is the likely effectiveness and proportionality of:

- **the FCA setting out its expectations about how AFMs should demonstrate that they are acting in the best interests of unitholders**

We believe that FCA should strengthen this duty in line with our investor statement on investor obligations and duties by:⁵

- clarifying investors' duties, in particular, in relation to the integration of ESG issues into investment practice
- ensuring that policies align with this clarification of investors' obligations and duties and provide oversight to ensure policies are effectively implemented.

The PRI's work on investor duties builds on the recommendations of the Kay Review and the UK Law Commission's report *Fiduciary Duties of Investment Intermediaries*. Fiduciary duty requires investors to consider long-term value drivers in investment processes. ESG factors are a core part of such an assessment.

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

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

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

⁵ Global Statement on Investor Obligations and Duties: <http://www.fiduciaryduty21.org/investor-statement.html>

⁶ *Fiduciary Duties of Investment Intermediaries*, UK Law Commission 2014

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

⁸ The Occupational Pension Schemes (Investment) Regulations, para 4 (3) (Investment by Trustees): "The powers of investment, or the discretion, must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole."

It is within this context that the FCA's remedies are most likely to be effective by clarifying:

- that the duties of loyalty, prudence and competence apply to all investors across the investment chain
- that investors must pay attention to long-term investment value drivers, including ESG issues, in their investment processes, in their active ownership and voting activities.

All actors within the investment system, including asset managers, must act with due care, skill and diligence and act in the interests of their beneficiaries and clients. The FCA has identified that there are gaps and variations in both the specific obligations and duties that are placed on investors and we welcome efforts to strengthen the duty of asset managers to act in the best interests of investors.

The PRI believes that asset managers need to consider long-term investment value drivers, which include ESG issues, in their investment practices. Not to do so is failure of their duty to beneficiaries and investors. Our in-depth assessment of the UK and other major international markets found that standards of practice across the investment industry be need to raised several areas⁹:

- the obligations that investment organisations owe to their beneficiaries and clients. The global financial crisis demonstrated that standard investment practices were inadequate to protect clients and beneficiaries from significant financial losses resulting from systemic risks and low probability/high consequence events.
- many institutional investors do not systematically integrate ESG issues into their investment processes, and relatively few engage with the companies or entities in which they are invested. This is despite growing evidence that these are important drivers of investment performance.¹⁰
- the perception that ESG issues do not add value to investment decision-making needs to be addressed. Many investors and asset managers are yet to be convinced that focussing on ESG issues can add value to investment decision-making. These perceptions persist despite wide dissemination of research that demonstrates that ESG integration can help limit down-side investment risks and can significantly enhance investment performance. There are also concerns that the costs of analysing ESG issues are likely to outweigh the investment benefits that accrue.

Do you have views on how firms should demonstrate that they have acted in the best interests of investors?

Fund managers should have a process in place to evaluate emerging risks, including ESG, and where appropriate, integrate them into investment processes. They could demonstrate this by reporting to their institutional clients with the expectation that institutional investors will use that to report to beneficiaries. Steps that should be reported include:

⁹ Fiduciary Duty in the 21st Century: https://www.unpri.org/download_report/6131

¹⁰ Fiduciary Duty in the 21st Century: UK Roadmap: https://www.unpri.org/download_report/24187

- show that they have recognised relevant ESG risks
- analyse how ESG risks might affect investment returns over the short, medium and long-term.
- explicitly manage ESG risks, and not assume that the risks are automatically managed by other risk management strategies.
- interrogate and challenge the individuals or organisations (e.g. companies) to ensure that these risks are being effectively managed.
- establish processes that enable them to demonstrate the actions they have taken.

MEASURES TO HELP RETAIL INVESTORS IDENTIFY WHICH FUND IS RIGHT FOR THEM

Would it be proportionate and effective to require fund managers to be more specific with investors by clarifying an upfront objective and tracking performance against that objective over an appropriate time period?

Yes we believe that this measure would be proportionate and effective because we think it is necessary for asset managers to be explicit about ESG integration in the investment approach of the fund. The PRI has developed a series of model clauses for inclusion in contracts between institutional investors and asset managers that could be adapted for retail investment management agreements (see Appendix).

How should fund managers and other market players communicate to allow investors to judge success over an appropriate time period? In what circumstances would it be appropriate to provide comparators, for example, performance of passive funds in the relevant market? Should we set out our expectations on using benchmarks, particularly when benchmarks are used to trigger performance fees?

We would recommend that communication measures go beyond market benchmarks and consider ESG issues to make it easier for investors to understand where they are investing. We would suggest that the FCA work with the Inclusive Economy Unit on SRI labelling and examine the introduction of SRI labelling in France.

Are there other metrics/indications/pieces of information that could give investors better insight into likely future returns?

As set out earlier in our comments, fiduciary duty requires consideration of ESG factors in investment decision-making and the test for consideration of a factor within the investment process is financial materiality. Fund managers should indicate that they evaluate the potential materiality of ESG risks and opportunities as a core part of prudent investment decision-making.

We would also recommend that fund managers provide meaningful disclosure in respect of their stewardship and active ownerships activities. This would include fund managers reporting annually on the financial outcomes and the environmental, social and governance outcomes that have resulted from these activities, and how stewardship activities have influenced its investment decisions.

REQUIRING INCREASED TRANSPARENCY AND STANDARDISATION OF COSTS AND CHARGES INFORMATION FOR INSTITUTIONAL INVESTORS

Whether institutional investors would benefit from standardised disclosure of asset management fees and charges?

Due to the disproportionality fragmented UK pension market, any further transparency and comparability of fund managers for pensions fund is welcome.

What fees and charges information should be included in a standardised disclosure framework?

Fund managers should report annually on the staff and other resources it has for the implementation of its responsible investment commitments and for the analysis of ESG issues, how its compensation structures aligns with the objectives of the mandate and report on portfolio turnover, including the costs incurred from portfolio turnover, and provide an explanation of any divergence from turnover expectations. This could include:

- annual fees
- performance-related fees
- employee compensations structures, including vesting and clawbacks
- turnover and trading costs
- investment in research

MEASURES TO IMPROVE THE USEFULNESS AND COMPARABILITY OF PERFORMANCE INFORMATION USED BY TRUSTEES

Are there better ways in which information could be presented to trustees, particularly member nominated trustees, in order for them to assess the performance of their scheme? How could this be achieved?

The content of reporting is important, but measures should also focus on the distinction between reporting frequency and time horizons. Pension funds and life insurer liabilities are generally very long-term, whereas fund managers generally report quarterly on trustees' request. Reporting data should also reflect pension fund and insurer asset and liability management requirements, alongside short-term performance. This would help trustees contextualise short-to medium performance in a long(er)-term perspective.

EXPLORING THE POTENTIAL BENEFITS OF GREATER POOLING OF PENSION SCHEME ASSETS

To what extent would pooling result in better outcomes for investors?

While we recognise the good practices adopted by some small schemes, there is evidence that scheme size is correlated to good governance and better ESG outcomes. Careful outsourcing can address many of these scale-related issues – asset managers or through fiduciary management structures – but, size can convey a number of advantages. It can reduce management and advisory costs through giving asset owners a better negotiating position with service providers.

Scale can also embed trustee expertise and enable engagement with investee companies through in-house fund resourcing and size of holding.

Are there logistical challenges involved in pooling assets? How could we overcome these?

Given the fragmented nature of the UK pensions market, it seems unlikely that consolidation will occur at scale in the absence of regulatory encouragement. We therefore recommend:

- trustees reflect on whether scale has a negative impact on scheme governance and performance, including the consideration of ESG factors and costs. We recommend this occurs every three years, with results being reported to TPR and to scheme members. TPR should monitor the results.
- the Government simplify procedures for pension scheme consolidation.

Regardless of size, scheme governance remains a challenge issue, particularly in the DC contract-based market. The expanded governance standards for DC schemes, resulting in Independent Governance Committees (IGCs), are now required for contract-based DC. These are welcome but need to be strengthened because good scheme governance structures are a precursor of good ESG practices. The terms of reference for IGCs should be extended to include long-term value creation, product suitability and engagement practices. IGCs should be made expressly subject to FCA rules and given sufficient resources to perform oversight and analysis of provider practice.

CONSULTATION ON WHETHER TO MAKE A MARKET INVESTIGATION REFERENCE TO THE CMA ON THE INSTITUTIONAL ADVICE MARKET AND BRING THE PROVISION OF THIS ADVICE WITH THE FCA'S REGULATORY PERIMETER.

Whether the FCA should recommend that HM Treasury brings the provision of advice provided by investment consultants to institutional investors within the regulatory perimeter

The PRI strongly supports this recommendation for three reasons:

1. the role consultants play in trustee decision-making.
2. the importance of asset owner investment decision-making through the investment chain.
3. the importance of asset allocation.

These recommendations reflect those made to The Pensions Regulator's [21st Century Trusteeship and Governance](#) consultation in 2016. Individual acts of Trustees are personal and conscious, but must be taken on receipt of "proper advice". In practice, many Trustees lack the confidence to scrutinize or challenge advice, and hence become overly reliant on the advice of investment consultants. As a consequence, consultants strongly influence strategic asset allocation decisions and investment strategies of UK pension schemes.

The key strategic position of investment consultants makes analysis of their practice particularly important. It also amplifies the importance of the knowledge and intention of asset owners in their interaction with investment consultants.

Several studies have indicated that it is the overall asset allocation decision that has the dominant influence (along with scheme cost) in determining investment returns, rather than the selection of particular investments.¹¹ Decisions over the weighting of asset classes within an investment portfolio would generally be considered to be “generic advice”. By contrast, advice relating to specific investments, such as the investment in a pooled fund vehicle, would be “advice on the merits” and subject to FCA regulation. Our interviews with over 40 UK investors and stakeholders indicates that the regulatory distinction between advice on asset-allocation and advice on specific investments is unhelpful.¹²

Are there alternative remedies that we should also consider to allow better monitoring and assessment of advice provided by investment consultants and employee benefit consultants?

As noted earlier, we consider that the terms of the FCA’s study are too narrow, failing to directly address ESG issues as a potential driver of competition and a growing unmet investment industry need. Given the significant investment risk from un-assessed ESG issues, we propose that the FCA review whether an investment consultant’s failure to include such factors in advice is a breach of their duty of care given the fiduciary duties of the investors they serve.

It is worth noting that other markets have engaged in broader regulation of investment consultants and the management of conflicts of interest. For instance, the US SEC and Department of Labour prepared a questionnaire for fiduciaries to ask questions of their advisors (to help them evaluate the extent of their conflicts and the standard to which their advice would be subject). The FCA could provide a similar tool-kit approach for investment consultants and also for the provision of fiduciary management.

¹¹ The Asset Allocation Debate: Provocative Questions, Enduring Realities: <http://www.vanguard.com/pdf/icradd.pdf>

¹² Fiduciary Duty in the 21st Century: UK Roadmap: https://www.unpri.org/download_report/24187

APPENDIX – MODEL CONTRACT CLAUSES

- **Investment Policy Statement:** *In carrying out its duties under this agreement, the Investment Manager will manage the client's portfolio in line with the client's investment policy statement and responsible investment policies, copies of which are attached as Appendix 1 to this agreement. The manager will also ensure the portfolio is managed in line with the Principles for Responsible Investment, to which the client is a signatory.*
- **ESG integration:** *Consistent with its fiduciary duties and with the client's investment policy statement and responsible investment policy (copies of which are attached as Appendix 1 to this agreement), the Investment Manager will establish a structured process for integrating environmental, social and governance issues into its investment processes and decision-making. The Investment Manager will ensure that its staff apply due care and diligence to following this process. The Investment Manager will report annually on the implementation of this process and on how the analysis of environmental, social and governance issues has influenced investment decisions and portfolio performance.*
- **Aligning time horizons:** *The Investment Manager will have a process for monitoring current or potential investments in relation to relevant long-term factors such as ESG concerns. The Investment Manager will ensure that its staff apply due care and diligence to applying this monitoring process, including considering the extent to which such long-term factors generate investment risks or opportunities. The Investment Manager will report annually on the implementation of this process. The Investment Manager will report annually on portfolio turnover, including the costs incurred from portfolio turnover. The Investment Manager will, as part of this reporting, provide an explanation of any divergence from expected risk-adjusted returns.*
- **Stewardship:** *The Investment Manager will be an active owner, implementing a programme of engagement and, where relevant, voting, aligned with the Client's responsible investment policy statement and policies (copies of which are attached as Appendix 1 to this agreement). The Investment Manager will agree engagement priorities with the client on an annual basis. Where appropriate, the Manager will provide the Client with the opportunity to join company meetings. The Investment Manager will participate in, and promote, stewardship codes in countries relevant to the investment portfolio. The Investment Manager will report annually on the financial outcomes and the environmental, social and governance outcomes that have resulted from these activities, The Investment Manager will also report on how stewardship activities have influenced its investment decisions.*
- **Public policy engagement:** *The Investment Manager will allocate resources to public policy engagement on responsible investment-related issues, in line with the Client's investment policy statement and responsible investment policies, copies of which are attached as Appendix 1 to this agreement. The Investment Manager will agree engagement priorities with the Client on an annual basis, and will report annually on progress against these priorities.*
- **Reporting:** *In addition to the specific reporting requirements above, the Investment Manager will report annually on:*
 - *The staff and other resources it has for the implementation of its responsible investment commitments and for the analysis of ESG issues;*
 - *How its compensation structures align with the objectives of the mandate;*

- *The internal and external ESG research it uses in its investment research and decision-making, including information on its chosen research providers and on research expenditures;*
- *How its responsible investment and ESG-related activities (investment research and decision-making, active ownership, policy engagement) have affected the underlying value and strategy of the portfolio. The Manager will allow access by the Client to its staff and systems to monitor ESG integration in investment decision-making.*