FIDUCIARY DUTY IN THE 21ST CENTURY
ACKNOWLEDGEMENTS

This report has been prepared by: Rory Sullivan, Will Martindale, Elodie Feller and Anna Bordon.
Design by: Alessandro Boaretto, PRI

CORE PROJECT TEAM
• Rory Sullivan, Senior Advisor
• Will Martindale, Head of Policy, PRI
• Elodie Feller, Investment Commission Coordinator, UNEP FI
• Anna Bordon, Policy and Research Officer, PRI
• Jaime Garcia-Alba, Head, Private Sustainability Finance and Reporting, UN Global Compact

PROJECT STEERING COMMITTEE
• Fiona Reynolds, Managing Director, PRI
• Nick Robins, Co-Director, UNEP Inquiry
• David Pitt-Watson, Co-Chair, UNEP FI
• Gavin Power, Deputy Director, UN Global Compact

ACKNOWLEDGEMENTS TO CONTRIBUTORS

The following law firms provided legal research assistance in the production of this report. However, all opinions expressed in this report are those of the UNEP Finance Initiative, the PRI, the UN Global Compact and the UNEP Inquiry and do not necessarily reflect the views of these firms: Bowman Gilfillan, King & Wood Mallesons, McCarthy Tétrault LLP, NagashimaOhno&Tsunematsu, Veirano Advogados.

We would like to thank the PRI, UNEP FI and UN Global Compact teams for their support in coordinating the interviews and for reviewing earlier drafts of this report, in particular: Adrian Betrand, Alyssa Heath, Caitlin Casey, Danielle Chesebrough, Dustin Neuneyer, Eric Usher, Fiona Reynolds, Geeda Haddad, Ingvild Soerensen, Jaime Garcia Alba, Joy Frascinella, Karii Nomura, Maria Lettini, Melanie Klebeck, Mengqi Cai, Michiyos Morisawa, Nathan Fabian, Robert Bartram, Rubi Hernandez, Ryan Cunningham, Sabina Timco, Shalini Samuel, Sonal Mahida, Tatiana Assali, Yuki Yasui, Yulia Sofronova.

For any further questions email: elodie.feller@unep.org or will.martindale@unpri.org.
DEFINITIONS

ESG integration refers to the process of taking account of ESG data and information in investment research and decision-making processes. The definition is broad to account for the different ways in which investment organisations consider ESG issues (such as screening, fundamental analysis, thematic analysis). The key point is that decisions are driven by the financial rather than ethical implications of the issue in question.

Active ownership refers to the manner in which investors use their formal rights (proxy voting and filing shareholder resolutions) and their position as an investor to influence the activity or behaviour of companies or other entities.

Responsible investment is an approach to investment that explicitly acknowledges the relevance to the investor of ESG factors, and of the long-term health and stability of the market as a whole. It recognises that the generation of long-term sustainable returns is dependent on stable, well-functioning and well governed social, environmental and economic systems. Responsible investment can be differentiated from conventional approaches to investment in two ways. The first is that timeframes are important; the goal is the creation of sustainable, long-term investment returns not just short-term returns. The second is that responsible investment requires that investors pay attention to the wider contextual factors, including the stability and health of economic and environmental systems and the evolving values and expectations of the societies of which they are part.
# CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forewords</td>
<td>05</td>
</tr>
<tr>
<td>Executive summary</td>
<td>09</td>
</tr>
<tr>
<td>Introduction: what is fiduciary duty and why is it important?</td>
<td>11</td>
</tr>
<tr>
<td>The changing landscape of fiduciary duty</td>
<td>14</td>
</tr>
<tr>
<td>A global roadmap for sustainable value creation</td>
<td>20</td>
</tr>
<tr>
<td>Country-specific recommendations</td>
<td>22</td>
</tr>
<tr>
<td>Country analysis</td>
<td>24</td>
</tr>
<tr>
<td>• Australia</td>
<td>25</td>
</tr>
<tr>
<td>• Brazil</td>
<td>31</td>
</tr>
<tr>
<td>• Canada</td>
<td>37</td>
</tr>
<tr>
<td>• European Union</td>
<td>43</td>
</tr>
<tr>
<td>• Germany</td>
<td>45</td>
</tr>
<tr>
<td>• United Kingdom</td>
<td>51</td>
</tr>
<tr>
<td>• Japan</td>
<td>59</td>
</tr>
<tr>
<td>• South Africa</td>
<td>65</td>
</tr>
<tr>
<td>• United States</td>
<td>72</td>
</tr>
<tr>
<td>Appendices</td>
<td>81</td>
</tr>
<tr>
<td>• Interviewees</td>
<td>81</td>
</tr>
<tr>
<td>• Global peer reviewers</td>
<td>84</td>
</tr>
<tr>
<td>• Further reading</td>
<td>85</td>
</tr>
</tbody>
</table>
FOREWORDS

Mr. Gore, chairman of Generation Investment Management, is a former vice president of the United States. Mr. Blood is senior partner of Generation Investment Management.

AL GORE AND DAVID BLOOD

Fiduciaries are tasked with the decision to buy, sell, or hold assets. There is no passive behaviour as a fiduciary; there is no "do nothing" task. Those who defend an obsolete interpretation of fiduciary duty sometimes justify the active omission of sustainability considerations by asserting that sustainability dynamics somehow have no impact on financial assets. Overwhelming evidence now shows, however, that they are simply mistaken. Sustainability is an important factor in the long-term success of a business. Therefore as with any other issue related to the prudent management of capital, considering sustainability is not only important to upholding fiduciary duty, it is obligatory.

This report is a landmark piece in the global dialogue on the relevance of sustainability to fiduciary duty. By clearly defining the full remit of fiduciary duty and providing recommendations for how it should be implemented, this work serves as a definitive guide for any fiduciary unsure of the role that sustainability should play in their decision-making process.

In particular, the Global roadmap for ESG integration in this report provides key insights for various stakeholders, outlining the need to recalibrate the scope of fiduciary duty at an industry-wide level. Generation Investment Management is deeply committed to this viewpoint and we look forward to working with the authors of this report to advance the recommendations they have put forth.

The importance of sustainability to business and investing is intensifying as financial markets are increasingly forced to address challenges posed by the scarcity of natural resources, the effects of unabated carbon emissions, rapid urbanisation and the widening inequality of wealth and incomes, to name just a few. As the context of business and investing continues to shift, implementing a framework for allocating capital that embeds sustainability into it will be critical to successfully navigate the transition. Prudent fiduciaries of capital should use this report to adjust their actions accordingly.
Fiduciary duty is central to the functioning and credibility of the Brazilian investment market. As an asset owner, we are required by law to disclose potential conflicts of interest and to perform our activities using all the care and diligence that an active and honest person would use when managing his or her own business. These requirements are reinforced by strong self-regulatory requirements that are enforced by key market actors.

Brazilian investors are increasingly focusing the fiduciary duty debate on the convergence between responsible investment and financial aspects. Of particular importance has been Resolution 3.792, issued in 2009 by the Brazilian Monetary Council (Conselho Monetario Nacional (CMN)), which requires closed pension funds to state whether they take account of environmental and social issues in their investment practices. This change is being reinforced by the growing awareness of the investment implications of social and environmental issues such as access to water, child labour and workers’ rights.

As asset owners, we recognise that we have responsibilities to deliver pension benefits to our beneficiaries and we believe responsible investment is a keystone to continue reaching this objective, now and in the future. This important report reinforces the integration of environmental, social and governance issues in our investment practices and in our dialogue with companies. This can only be positive for investors and for wider society over the long-term.
CORIEN WORTMANN-KOOL

ABP is one of the world’s largest pension funds, managing over EUR 350bn on behalf of Dutch pensioners. With this scale comes the obligation to optimize risk-adjusted returns and invest in a responsible manner. This is driven by a variety of factors: by our own beliefs about our responsibilities to our beneficiaries, by the consensus in the Netherlands that pension funds have broader societal responsibilities, by Dutch pension law, by the emerging body of European law, and by our beneficiaries themselves.

We recognize that our fiduciary obligations are not confined to the manner in which we carry out our own investment activities. Our ability to deliver on our long-term responsibilities to our beneficiaries is dependent on stable and resilient capital markets and economies, and on healthy and sustainable social and environmental systems.

This report provides a compelling roadmap to help advance more long term thinking in financial markets. It is clear that progress will depend on effective collaboration between investors, policymakers and other stakeholders. We are looking forward to being part of this process.
Sound logic informs the ESG investment thesis, grounded in the belief that value creation is influenced by more than financial capital alone, especially longer term. There is mounting evidence that ESG issues can affect the performance of investment portfolios and have implications for a company’s earnings and prospects as well as broader economic functioning.

This view is informed both by our own research as well as a body of academic and industry study. In parallel, active ownership plays a prominent role in our duty to act as stewards of our clients’ assets. We expect strong governance standards from our investee companies and our direct engagement with them focuses on advocating change where poor ESG practices place shareholder value at risk.

‘Fiduciary Duty in the 21st Century’ offers a compelling argument for investors which may be circumspect of the compatibility of ESG with their duties as a fiduciary. For those already cognizant of the relevance of sustainability issues to investment and active ownership practices it stands as a stout affirmation. Regardless of the readers position it’s a pivotal contribution to the literature on a critical aspect of the bedrock of investment.
EXECUTIVE SUMMARY

The purpose of this report is to end the debate about whether fiduciary duty is a legitimate barrier to investors integrating environmental, social and governance (ESG) issues into their investment processes.

Its precursor, a 2005 report commissioned by UNEP FI from law firm Freshfields Bruckhaus Deringer concluded that integrating ESG considerations into investment analysis is “clearly permissible and is arguably required.”

In the decade that followed, many asset owners have made commitments to responsible investment. Many countries have introduced regulations and codes requiring institutional investors to take account of ESG issues in their investment decision-making. These changes - in investment practice and in public policy - demonstrate that, far from being a barrier, there are positive duties on investors to integrate ESG issues.

Failing to consider long-term investment value drivers, which include environmental, social and governance issues, in investment practice is a failure of fiduciary duty.

When evaluating whether or not an institutional investor has delivered on its fiduciary duties, both the outcomes achieved and the process followed are of critical importance. For example, a decision not to invest in a high-carbon asset because of financial concerns about stranded assets is likely to be seen as consistent with fiduciary duties, providing that the decision is based on credible assumptions and robust processes.

Despite significant progress, many investors have yet to fully integrate environmental, social and governance issues into their investment decision-making processes.

This report identifies a series of challenges:

- Outdated perceptions about fiduciary duty and responsible investment. This is particularly the case in the United States where lawyers and consultants too often characterise ESG issues as non-financial factors.
- A lack of clarity within prevailing definitions of fiduciary duty about what ESG integration means in practice and, in particular, whether active ownership and public policy engagement form part of investors’ fiduciary duties.
- Limited knowledge of the evidence base for responsible investment, including the strength of the relationship between ESG issues and investment performance.
- Lack of transparency on responsible investment practices, processes, performance and outcomes, limiting investors’ accountability to their beneficiaries, their clients and wider society.
- Inconsistency in corporate reporting, including inadequate analysis of the financial materiality of ESG issues, making it hard to assess investment implications.
- Weaknesses in the implementation, oversight and enforcement of legislation and industry codes on responsible investment.

Our research finds that fiduciary duties have played, and continue to play, a critical role in ensuring that fiduciaries are loyal to their beneficiaries and carry out their duties in a prudent manner. However, we conclude that action is needed to modernise definitions and interpretations of fiduciary duty in a way that ensures these duties are relevant to 21st century investors.
To overcome these challenges, this report proposes a series of recommendations for institutional investors, financial intermediaries and policymakers.

In particular, policymakers and regulators should:

- Clarify that fiduciary duty requires investors to take account of ESG issues in their investment processes, in their active ownership activities, and in their public policy engagement.
- Strengthen implementation of legislation and codes, clarifying that these refer to ESG issues, and require investor transparency on all aspects of ESG integration, supported by enhanced corporate reporting on ESG issues.
- Clarify the expectations of trustees’ competence and skill and support the development of guidance on investor implementation processes, including investment beliefs, long-term mandates, integrated reporting and performance.
- Support efforts to harmonise legislation and policy instruments on responsible investment globally, with an international statement or agreement on the duties that fiduciaries owe to their beneficiaries. This statement should reinforce the core duties of loyalty and prudence, and should stress that investors must pay attention to long-term investment value drivers, including ESG issues, in their investment processes, in their active ownership activities, and in their public policy engagement.

Integrating ESG issues into investment research and processes will enable investors to make better investment decisions and improve investment performance consistent with their fiduciary duties. This will result in capital being allocated towards well-governed companies, putting investors in a better position to contribute to the goals of a greener economy and a more sustainable society.
INTRODUCTION: WHAT IS FIDUCIARY DUTY AND WHY IS IT IMPORTANT?

Fiduciary duties are imposed upon a person or an organisation who exercises some discretionary power in the interests of another person in circumstances that give rise to a relationship of trust and confidence. They are of particular importance in asymmetrical relationships; these are situations where there are imbalances in expertise and where the beneficiary has limited ability to monitor or oversee the actions of the entity acting in their interests.

While the core concepts of fiduciary duty remain as relevant to today’s investment markets as they have ever been, investors with fiduciary duties need to address fundamental questions such as:

- Should investors take account of environmental, social and governance (ESG) issues in their investment processes and decision-making?
- Should investors encourage higher standards of ESG performance in the companies in which they are invested?
- Do investors have a responsibility to support the integrity and stability of the financial system?
- How should investors respond to wider systemic risks – and opportunities – such as those presented by climate change?

BACKGROUND

In 2005, a group of investment managers organised under the United Nations Environment Programme Finance Initiative (UNEP FI) commissioned the law firm Freshfields Bruckhaus Deringer to publish the ground-breaking report titled A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment (commonly referred to as the Freshfields report). The report, in what was seen as a radical conclusion at the time, argued that “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.”

What is Fiduciary Duty?

Fiduciary duties (or equivalent obligations) exist to ensure that those who manage other people’s money act in the interests of beneficiaries, rather than serving their own interests. The most important of these duties are:

- Loyalty: Fiduciaries should act in good faith in the interests of their beneficiaries, should impartially balance the conflicting interests of different beneficiaries, should avoid conflicts of interest and should not act for the benefit of themselves or a third party.
- Prudence: Fiduciaries should act with due care, skill and diligence, investing as an ‘ordinary prudent person’ would do.

Despite the conclusions of the Freshfields report, many investors continue to point to their fiduciary duties and to the need to deliver financial returns to their beneficiaries as reasons why they cannot do more on responsible investment.

OUR OBJECTIVES

The starting point for our research was the question of whether there is a need to reframe or redefine fiduciary duty in a way that is relevant for 21st century investors. We wanted to explore whether fiduciary duty is a legitimate obstacle to investors taking account of ESG issues in their investment processes. We also wanted to explore the question of whether investors’ fiduciary duties require them to consider the impacts of their investment activities on wider society and on the environment and, if so, what the implications for investment practice might be.
LEGAL CONTEXT
In each of the eight jurisdictions examined in this report, investors have varying degrees of discretion as to how they invest the funds they control; it may be narrow, such as for tailored mutual funds where the beneficiary specifies the asset profile and only the day-to-day stock selection and other management tasks are left to the investor, or it may be wide, as with many occupational pension funds, where very few limits are typically placed on the way the fund may be managed. Some public funds are subject to considerable state control and the discretion afforded to these investors may be further narrowed by parameters set by government.

Within the discretion left to the investors, certain legal rules define their ability to integrate ESG considerations into their decision-making. It is these rules that are the subject of this report.

COMMON LAW VS CIVIL LAW JURISDICTIONS
In the common law jurisdictions covered by this report – Australia, Canada, South Africa, the UK, the US – fiduciary duties are the key source limits of the discretion of investment decision-makers, aside from any specific constraints imposed contractually or by regulation. These duties are articulated in statute and decided in the courts: some rules are open to re-interpretation over time or when applied to new facts. In the US, for example, the decision-maker’s duty is to exercise reasonable care, skill, and caution in pursuing an overall investment strategy that incorporates risk and return objectives reasonably suitable to the trust.

In countries where civil law applies – Brazil, Germany, Japan – any obligations equivalent to ‘fiduciary duties’ will be set-out in statutory provisions regulating the conduct of investment decision-makers and in the governmental and other guidelines that assist in the interpretation of these provisions. The content of each of these statutory provisions differs slightly between jurisdictions and depending on the type of institutional investor, but common themes include:

• Duty to act conscientiously in the interests of beneficiaries – this duty is expressed in different terms, with jurisdictions using terms such as “good and conscientious manager” (Japan) or “professionally” (Germany).
• Duty to seek profitability.
• Recognition of the portfolio approach to modern investment, either in express terms or implicitly in the form of requirements to ensure adequate diversification.
• Other duties relating to liquidity and limits on the types of assets that may be selected for certain types of funds.

In all jurisdictions, the rules that affect investment decision-making take the form both of specific laws (about the types of assets that are permitted for certain types of investment, and the extent to which the assets of a fund may be invested in specific asset classes or be exposed to specific issuers or categories of issuers, for example) and general duties that must be fulfilled (such as duties to ensure investments are adequately diversified).

TREATMENT OF ESG ISSUES
In none of the jurisdictions do the rules exhaustively prescribe how investors should go about integrating ESG opportunities and risks in their investment practices and processes, and on the timeframes over which they define their investment goals. In most cases, it is left to investors to determine the approach that will enable them to meet their legal obligations in the particular circumstances.

When evaluating whether or not an institutional investor has delivered on its fiduciary duties, courts will look at the evaluation and integration process of ESG issues into the investment decision-making.

EVOLUTION OF FIDUCIARY DUTY
Over the past decade, there has been relatively little change in the law relating to fiduciary duty.
However, there has been a significant increase in ESG disclosure requirements for asset owners and investment managers and in the use of soft law instruments such as stewardship codes that encourage investors to engage with the companies in which they are invested. Many of the interviewees for this project commented that while the law may not change quickly, there is likely to be increased use of disclosure requirements and soft law measures to encourage investors to pay greater attention to ESG issues in their investment practices and processes.

In addition, the economic and market environment in which the law is applied has changed dramatically. Factors such as globalisation, population growth and natural resource scarcity, the internet and social media, and changing community and stakeholder norms all contribute to the evolution in the relevance of ESG factors to investment risk and return. This necessarily changes the standards of conduct required of fiduciaries to satisfy their duties under the law.

“The concept of fiduciary duty is organic, not static. It will continue to evolve as society changes, not least in response to the urgent need for us to move towards an environmentally, economically and socially sustainable financial system.”

Paul Watchman (Honorary Professor, School of Law, University of Glasgow)
THE CHANGING LANDSCAPE OF FIDUCIARY DUTY

INVESTMENT PRACTICE

More investors take account of ESG issues in their investment processes …

Many of the interviewees for this research commented that, far from the radical statement it appeared at the time of the 2005 Freshfields report, the argument that ESG issues can be material and that investors should, therefore, take account of these issues is no longer controversial.

Interviewees pointed to issues as diverse as climate change regulation, labour rights, tax, bribery and corruption, changing demographics and consumer expectation as illustrations of how ESG issues can affect investment value and investment performance. They pointed to the growth in the quality and quantity of sell-side research on the investment implications of ESG issues as tangible evidence that the investment relevance of these issues is starting to be accepted within the investment industry.

The fact that an increasing number of institutional investors have high level commitments to integrate ESG issues into their investment processes and to engage with companies on ESG issues was also highlighted as tangible evidence of change within the investment industry.

…although perceptions of materiality differ…

On performance, the evidence from the academic and practitioner literature is seen by most interviewees as being robust enough to argue that, at a minimum, fiduciaries should consider these issues as part of their investment process. There is, however, an important difference in practitioners’ perceptions of corporate governance issues and social and environmental issues.

Interviewees consistently stated that corporate governance issues are the most robustly tested and understood in terms of their impacts on investment performance. They pointed to the legal elucidation of governance issues (e.g. the Enron case or the SEC decisions on credit rating agencies), to broadly accepted principles on the characteristics of good governance, to the quality of corporate reporting and to the robust academic evidence.

In contrast, many interviewees said that the relationships between specific social and environmental issues and investment performance are often not clear, that the investment tools for analysing these issues remain relatively underdeveloped (although a number pointed to the work that has been done on climate change scenarios as a notable exception) and that a lack of standardised reporting on these issues makes it difficult to draw conclusions on their financial implications.

Why are Investors Interested in ESG Issues?

The analysis of ESG issues as an integral part of the investment process enables investors to make a full assessment of the risks and opportunities associated with particular investments. This allows them to make better investment decisions and facilitate more accurate valuations of businesses by the investment markets. It also contributes to a higher quality dialogue between companies and their investors on drivers of long-term value creation, provides incentives to companies to improve their governance and management of ESG issues, and encourages investors to proactively seek out opportunities presented by these issues.

This analysis and dialogue will result in capital being allocated towards well-governed companies, putting it in a better position to contribute to the goals of a greener economy and a more sustainable society.

While many countries now have policies that encourage long-term responsible investment…
In what looks like the start of a wider global trend, voluntary stewardship codes (where signatories to these codes commit to engage with the companies in which they are invested) have been developed by or in conjunction with the investment industry in the UK, Japan and South Africa. A number of interviewees, however, cautioned that these codes tend to be disproportionately focused on governance issues.

Interviewees commented that disclosure requirements such as Ontario’s pension standards legislation (PBA909), which will require pension funds to disclose information about whether ESG factors are incorporated into their investment policies and procedures, have been particularly important in stimulating boards of trustees to explicitly discuss ESG issues and to seek advice on how responsible investment is consistent with their fiduciary duties.

...many investors have yet to integrate ESG issues consistently and systematically into their investment processes...

Despite the progress that has been made in recognising the materiality of ESG factors, many investors have yet to integrate them into their investment processes or engage with the companies in which they are invested. In some cases, this is an issue of capacity, with smaller funds often lacking the resources, expertise or awareness, but interviewees said that even large asset owners that have made commitments are often weak in implementing them.

For example, the 2014 PRI Report on Progress found that just 49% of asset owners include requirements in their external manager agreements for reporting on ESG issues, while just 24% include voting requirements, and just 12% require engagement.

...as a consequence of weaknesses in policy implementation and of other changes in investment markets.

Interviewees commented that one of the reasons for this lack of progress is the weakness in the implementation of many of the stewardship codes and asset owner disclosure requirements. This is partly because many of these are relatively new and the relevant policymakers have concentrated on encouraging their adoption and uptake. It also reflects limited assessment: though most of these codes and disclosure requirements require some sort of public reporting on the number of signatories to a code or the number that have complied with the code or the disclosure requirements, there has been limited analysis of the actions that have been taken or of how the actions taken have affected investor or corporate practice.

Interviewees identified other shifts in investment markets, globally and within countries, that may affect how investors think about these issues. It is not clear how, if at all, they will affect investors’ approach to responsible investment or ESG integration. Particularly important changes include:

• The shift from defined benefit to defined contribution pension regimes in most markets, as a result of increases in lifespan, falling returns and increasing costs.
• The drive for pension fund consolidation to improve governance and cost efficiency, in particular for smaller funds.
• The need to reduce costs, with pension funds allocating large proportions of their assets to passive investments and pushing down fees.

FIDUCIARY DUTY

Fiduciary duty is not the obstacle it is commonly assumed to be...

Many of the asset owners interviewed for this research have taken a proactive approach to responsible investment or ESG integration. The consistent message, across all eight of the countries, was that fiduciary duty is not an obstacle to action. Most described fiduciary duty as a requirement that informs investment and management practice in a similar manner to aspects such as costs and investment returns. Some went further arguing that fiduciary duty creates a positive duty on them to take ESG issues into account in their investment practices, suggesting that a failure to take account of ESG issues could be seen as a breach of their fiduciary duties.

...although fiduciary duty is often presented as an excuse for not taking action.
However, the interviewees commented that asset owners and advisers often point to fiduciary duty as the reason why they cannot integrate ESG issues into their investment processes or engage with companies on these issues. This argument is often underpinned by the assumption that a focus on ESG issues requires a trade-off in investment performance. This is particularly important in the US, where interviewees pointed to the common belief that investors can only pursue corporate governance or non-financial issues if it can be clearly demonstrated that these activities do not harm the value of investment assets.

Fiduciary duty is just one reason why asset owners are not embracing responsible investment; it may not even be the most important barrier. Interviewees noted that other areas to consider include:

• Resource constraints – not least because of the growing complexity of the regulatory and other requirements faced by pension funds.
• Knowledge and understanding of ESG issues – both in terms of how ESG issues might affect investment performance and of how ESG integration and responsible investment might be implemented within the organisation.
• Personal values and perceptions – notably, the common misperceptions that ESG issues are purely ethical issues, that a focus on ESG issues involves compromising investment performance and that it is difficult to add investment value through a focus on ESG issues.
• Competing organisational priorities – such as, risk management and funding requirements that may lead to an excessive focus on short-term performance.
• The lack of consensus on good or best practice standards for responsible investment.

Legally, fiduciary duty is a process test…

There was consensus among all of the lawyers interviewed, across all the jurisdictions, that when evaluating whether or not an institution has delivered on its fiduciary duties, courts will distinguish between the decision-making process and the resulting decision. The law is reluctant to test fiduciaries against the perfect wisdom of hindsight, or second-guess judgments that inherently involve a balance of commercial risks, providing that the fiduciaries can demonstrate that they applied an appropriate degree of diligence in their good-faith pursuit of beneficiaries’ interests.

…which means that investors are encouraged to take a proactive, long-term approach on ESG issues.

Though regulatory authorities generally do not take a view on whether or not asset owners should invest in particular sectors or activities, they do expect asset owners to be aware of and to manage ESG risks, and to pay close attention to decisions that lead to skews in portfolios. Regulatory authorities will tend to look closely at investment decisions that expose funds to particular risks (e.g. a high-carbon portfolio or a portfolio with a weighting to renewable energy) and will expect them to explicitly assess the implications for the overall risk profile of the fund.

This suggests that asset owners may take account of wider ESG issues, so long as there is a clear focus on beneficiaries’ interests. In that context, for example, a decision not to invest in coal mines (e.g. because of concerns about these assets being stranded as a result of climate change policy) is likely to be seen as consistent with fiduciary duties so long as this decision is based on credible assumptions and a robust decision-making process. This requires trustees to have the discipline to set out their investment beliefs, to be prepared to review the investment outcomes achieved and to have the willingness to change if the data changes or if it is clear that the decision is causing significant damage to the beneficiaries’ financial interests.

Interviewees generally saw this wide discretion as being positive for ESG integration, but some cautioned that this discretion may make it difficult for beneficiaries to hold trustees to account. One interviewee cited climate change as an example, noting that beneficiaries would find it very difficult to challenge trustees’ decision not to take climate change into account if the trustees had reviewed the evidence, taken advice from their investment consultant and deemed there to be no associated risk to the portfolio.
FIDUCIARY DUTY IN THE 21ST CENTURY

ANALYSING AND ASSESSING ESG RISKS: THE CASE OF CLIMATE CHANGE

Fiduciaries need to be able to show that they have identified and assessed the risks (to companies and to their portfolios). In the case of climate change, for example, this would require them to:

- Show that they have recognised relevant risks (even if they are sceptics on the issue of climate change).
- Analyse how climate change might affect investment returns over the short, medium and long-term.
- Explicitly manage the risks, and not assume that the risks are automatically managed by other risk management strategies.
- Interrogate and challenge the individuals or organisations (e.g. investment managers, companies) to ensure that these risks are being effectively managed.
- Establish processes that enable them to demonstrate the actions they have taken.

STAKEHOLDERS

Beneficiaries are a missing link and are likely to remain so.

The interests of beneficiaries are central to definitions of fiduciary duty. Traditionally, beneficiaries’ best interests have been narrowly defined as financial interests, which investors would therefore often be well-placed to make their own judgements on without consulting beneficiaries. Recent policy discussions, however, (e.g. the UK discussions stimulated by the Kay Review since 2012) have argued that fiduciaries should take account of their beneficiaries’ views as to what constitutes their best interests.

The merits of this argument were acknowledged by interviewees, but they pointed to three major barriers to change:

- Most beneficiaries have limited understanding of or interest in how their pensions are being invested so long as the pension promise is being met.
- Beneficiaries are unlikely to agree on how their pension fund should address ESG issues.
- It is difficult to engage meaningfully with beneficiaries, in particular for large funds, which can have tens of thousands of beneficiaries.

Some interviewees offered challenges to these assumptions:

- Pension fund trustees engage successfully with beneficiaries on a variety of other, often highly complex, issues relating to their retirement benefits.
- The purpose of canvassing beneficiaries' views is not to reach consensus on a fund’s approach to a specific ethical issue, but to understand the importance assigned to ESG issues.
- Canvassing beneficiaries' views could, or even should, form part of trustees' own due diligence processes for understanding what ESG issues are likely to gain traction and be of investment significance.

Some interviewees said that not engaging with beneficiaries is the preferred approach precisely because it reduces the likelihood that beneficiaries will pressure trustees to take action on ESG issues.
Trustees are likely to face much more scrutiny.

Trustee capacity, competence and professionalism were identified as particularly important for responsible investment, and even more so in markets where responsible investment is relatively new or underdeveloped. Interviewees said that the asset owners that are most proactive and progressive on responsible investment tend to be those where the trustees have detailed knowledge and expertise of ESG issues.

Interviewees suggested that fiduciary duty requires trustees to be able to show that they have identified the relevant risks to their investments (including those arising from ESG issues), that they have put appropriate strategies in place to manage these risks and that they have overseen and monitored the actions of those charged with managing these risks (e.g. investment managers and companies).

Legal advisers and investment consultants’ interpretation of fiduciary duty play a critical role.

Obtaining advice from investment consultants is a legal requirement in many countries, and many jurisdictions allow asset owners to use the fact that they followed the advice given by investment consultants as a defence in court.

A recurring theme in the interviews was that the advice being given by these consultants and advisers – in particular in the US – is often based on a very narrow interpretation of fiduciary duty. Interviewees commented that most lawyers and consultants tend to advise their clients that the law requires them to have exclusive focus on financial returns, often in the erroneous belief that taking account of ESG issues will have a negative impact on investment returns. One interviewee noted: “they find it easier to say ‘no’ when asked about these issues”.

New fiduciaries may emerge from defined contribution schemes.

In many countries, the move from defined benefit to defined contribution pension schemes raises questions about the continued relevance of fiduciary duty concepts. In some cases, fiduciary duties continue to apply: for example, in South Africa, funds continue to be liable for outsourced activities, so they need to ensure that appropriate contracts are in place and that the fund has a right of recourse against the service provider. In other markets, the nature of the duty to beneficiaries of insurance companies, investment managers and sponsoring organisations in contract-based schemes (i.e. where the pension provider does not have fiduciary or equivalent obligations to the beneficiary in the way that a trustee would in a trust-based scheme) is not yet fully defined.

A number of interviewees expressed concern that while contract law protections would provide certain protections for beneficiaries, it might not deliver equivalent protection to fiduciary duty.

THE WIDER CHALLENGES – SUSTAINABILITY AND MATERIALITY

Interviewees pointed to the important contribution that investors can make on sustainability issues such as climate change by building consideration of the risks and opportunities presented by these issues into their investment processes, by analysing these risks and opportunities over the longer-term and by encouraging companies to adopt higher standards and better practices on these issues. These actions are all likely to be consistent with their fiduciary duties.

However, they also acknowledged that public policy would be a key determinant of the rate at which investors took action (e.g. to reduce portfolio-related emissions or to invest in clean technologies). They therefore suggested that investors need to continue to engage with governments to encourage the adoption of policy measures to correct market failures and to require companies and investors to internalise externalities as an integral part of their fiduciary duties.
The Treatment of Material and Non-material Issues

When we look at ESG issues, and at how fiduciary investors might address them in their investment practices and processes, it is useful to divide them into three categories (acknowledging that there is significant overlap between them):

- Financially material issues: These are issues that the investor sees as having the potential to significantly affect (positively or negatively) the financial performance of the investment over the relevant time period.

  Fiduciaries would expect these issues to be assessed in investment research and decision-making processes as a matter of course.

- Non-financially material issues: These are issues that, while they may be important to stakeholders, if managed well, do not present a significant threat to (or opportunity for) the business.

  Fiduciaries would expect companies to demonstrate that they are managing these issues effectively, and should intervene if they were concerned that a failure to manage these issues could lead to financial detriment.

- Wider social, economic and environmental issues: These are issues that have the potential to significantly affect the investors’ ability to deliver on its organisational or investment objectives but that may have limited financial impact within the relevant time period. For example, these could be issues that affect the stability and health of economic and environmental systems, or they could be issues that are, or have the potential to be, important to beneficiaries or other stakeholders.

  Investors that have made a commitment to responsible investment would be expected to build consideration of these issues into their investment research and decision-making processes, to play an active ownership role in the companies and other entities in which they are invested, and to engage with policymakers to encourage the development and implementation of appropriate policy responses to these issues.

Materiality is a dynamic concept, and the materiality of ESG issues evolves over time. This evolution is driven by changes in legislation and policy, by changes in risk and the understanding of risk, by changes in the social, environmental and economic impacts of the ESG issue in question, and by changes in societal (and beneficiary) expectations and norms.
A GLOBAL ROADMAP FOR SUSTAINABLE VALUE CREATION

Though there are variations between countries – reflecting national priorities, the current development of responsible investment in the country in question and prevailing legal requirements – our research suggests that in the following areas progress is needed globally:

INSTITUTIONAL INVESTORS
- Publish commitments to ESG integration and responsible investment, including explanations of how these commitments align with fiduciary duties.
- Implement these commitments effectively in investment processes.
- Monitor how investment managers (internal and external) are implementing these commitments.
- Report to beneficiaries on how these commitments have been implemented and the outcomes that have resulted.
- Ensure that trustees, boards and executives have the resources and knowledge to hold investment managers and advisers to account on ESG integration.
- Require companies to provide robust, credible and detailed accounts of their management of ESG issues, and of the financial significance of these issues.
- Engage policymakers on issues relevant to long-term performance, including strengthened corporate reporting.

INTERMEDIARIES – LEGAL ADVISERS, INVESTMENT CONSULTANTS (ACTUARIES), STOCK EXCHANGES, BROKERS AND DATA PROVIDERS
- Publish commitments to ESG integration and responsible investment, including explanations of how these commitments align with fiduciary duties.
• Implement these commitments effectively in research and advice provided to fiduciary clients.
• Report to fiduciary clients on how these commitments have been implemented and the implications for the research and advice provided.
• Advise fiduciaries that, as an integral part of fiduciary duties, they need to analyse and account for long-term value drivers, including ESG issues, in their investment practices and processes.
• Support research on the relationship between ESG issues and investment performance, and on the relationship between engagement and corporate performance.
• Support efforts to change market views on ESG issues by making these issues an integral part of professional training, through ensuring that ESG issues are an integral part of codes of professional ethics such as the CFA, and by raising market awareness of the investment case for ESG integration.

POLICYMAKERS AND REGULATORS
• Clarify that fiduciaries must analyse and take account of ESG issues in their investment processes, in their active ownership activities, and in their public policy engagement.
• Clarify that fiduciary duty requires that investors pay attention to long-term investment value drivers, including ESG issues.
• Encourage or require institutional investors to support public policy efforts promoting responsible investment.
• Require investor transparency on all aspects of ESG integration and investment practice.
• Require better corporate reporting on ESG issues and on how these affect business performance over the short and long term.
• Heighten expectations of trustee competence and skill.
• Better implement existing responsible investment legislation and policy instruments (e.g. stewardship codes and asset owner disclosure requirements) and clarify that these refer to environmental, social and governance issues, and analyse and report on how these affect investor and company performance.
• Support efforts to harmonise national and regional responsible investment legislation and policy instruments (e.g. stewardship codes and disclosure requirements).
• Develop an international statement or agreement on the duties that fiduciaries have to their beneficiaries, reinforcing the core duties of loyalty, prudence and competence and stressing that investors must pay attention to long-term investment value drivers (including ESG issues) in their investment processes, in their active ownership activities and in their public policy engagement.
• Support the development of guidance on implementation processes: investment beliefs, long-term mandates, integrated reporting and performance.

INTEGRATING ESG ISSUES IN COMPLIANCE WITH FIDUCIARY DUTY
Asset owners generally have significant freedom to decide how they wish to take account of ESG issues in their investment practices and processes. However, they should:
• Pay close attention to decisions that lead to skews in portfolios and explicitly assess the implications of these skews for the overall risk profile of the fund.
• Base investment decisions on credible assumptions (e.g. about future regulation) and a robust decision-making process.
• Be prepared to review the investment outcomes achieved.
• Be willing to change if the data changes or if it is clear that the decision is causing significant damage to the beneficiaries’ interests.
COUNTRY-SPECIFIC RECOMMENDATIONS

SUMMARY

In addition to the global recommendations for institutional investors, intermediaries and policymakers, we recommend the following country-specific actions:

AUSTRALIA:
The Australian Prudential Regulation Authority (APRA) should clarify that fiduciary duty requires asset owners to pay attention to long-term factors (including ESG factors) in their decision-making, and in the decision-making of their agents.

Australian regulators should clarify that responsible investment includes ESG integration, engagement, voting and public policy engagement.

BRAZIL:
Comissão de Valores Mobiliários (CVM) and Associação Brasileira das Entidades dos Mercados Financeiro e de Capitais (ANBIMA) should for asset owners and investment managers respectively:
- Clarify that fiduciary duty requires them to pay attention to long-term factors (including ESG factors) in their decision-making, and in the decision-making of their agents.
- Clarify that they are expected to take account of ESG issues in their investment processes and decision-making, and to proactively engage with the companies and other entities in which they are invested.

Superintendência Nacional de Previdência Complementar (Previc) should strengthen its oversight and implementation of Resolution 3.792 by analysing and reporting on the implementation of the environmental and social issues requirements of Resolution 3.792 and its effect on investor practice and performance.

CANADA:
The Office of the Superintendent of Financial Institutions Canada and the relevant pension regulators in each province should clarify that asset owners are expected to pay attention to long-term factors (including ESG factors) in their decision-making, and in the decision-making of their agents.

The federal government and the governments of the provinces should follow the example set by Ontario and introduce ESG disclosure legislation. The legislation should require regulators to:
- Review progress annually.
- Explain how asset owners integrate ESG issues into their investment processes.
- Analyse how these commitments have affected the actions taken and the outcomes achieved (where the outcomes relate to both investment performance and to the ESG performance of the entities in which they are invested).

EUROPEAN UNION
The European Commission should provide guidance to the competent member state authorities on how they should interpret fiduciary duty in the national legal context. This guidance should:
- Clarify that fiduciary duty requires asset owners to pay attention to long-term factors (including ESG factors) in their decision-making and in the decision-making of their agents.
- Clarify that responsible investment includes ESG integration, engagement, voting and public policy engagement.
- Encourage member states to ensure that fiduciary duty and responsible investment-related legislation is harmonised and consistent across Europe.
- Encourage member states to monitor the implementation of legislation and other policy measures relating to fiduciary duty and responsible investment, and report on the investment and other outcomes that result.
GERMANY:

**Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)** should require pension funds, pension institutions and insurers to:
- Adopt publicly available policies that explain how they address ethical, social and environmental concerns in the allocation of pension contributions.
- Publish a public annual report describing how these commitments have affected the actions taken and the outcomes achieved (where the outcomes relate to both investment performance and to the ESG performance of the entities in which they are invested).

**Pension funds** should publicly commit to responsible investment.

UNITED KINGDOM:

The **government** should amend the Occupational Pensions Schemes (Investment) Regulations to:
- Clarify that fiduciary duty requires them to pay attention to long-term factors (including ESG factors) in their decision-making, and in the decision-making of their agents.
- Clarify that responsible investment includes ESG integration, engagement, voting and public policy engagement.
- Require asset owners to report on how they implement their policies and statements of investment principles. The Pensions Regulator should ensure that asset owners provide meaningful disclosure, by providing guidance on reporting and by critically scrutinising their disclosure.

The **Financial Reporting Council (FRC)** should:
- Conduct a more detailed analysis of current implementation of the UK Stewardship Code by analysing asset owners’ oversight of their investment managers’ implementation and by analysing the investment and other outcomes that result from the code.
- Highlight those asset owners and investment managers that it considers to be doing a good job of implementing the stewardship code, and those whose implementation appears to be lagging.
- Strengthen the stewardship code by:
  - Making it clear that environmental and social issues are important drivers of long-term investment value.
  - Providing clear guidance to asset owners that outsource investment management (and associated activities) on how they are expected to deliver on their stewardship obligations.

**Corporate pension funds** should sign the stewardship code and make public commitments to responsible investment.

JAPAN:

The **Financial Services Agency (FSA)** should continue to monitor the implementation of the Japanese Stewardship Code, analysing asset owner oversight of their investment managers’ implementation and analysing the investment and other outcomes that result from the code.

The **Ministry of Health, Labour and Welfare (MHLW)** should require public and corporate pension funds to state how they integrate ESG issues into their investment decisions. As part of these requirements, MHLW should commit to:
- Review progress annually.
- Explain how asset owners integrate ESG issues into their investment processes.
- Analyse how these commitments have affected the actions taken and the outcomes achieved (where the outcomes relate to both investment performance and to the ESG performance of the entities in which they are invested).

**Corporate pension funds** should sign the stewardship code and publicly commit to responsible investment.

**Investment banks** should produce more research on the drivers of long-term investment value (including ESG factors).
SOUTH AFRICA:
The Financial Services Board should:

- Clarify that compliance with the requirements of Regulation 28, in particular those relating to ESG issues, should be seen as an integral part of the fiduciary duties imposed by the Pension Funds Act.
- Clarify that responsible investment includes ESG integration, engagement, voting and public policy engagement.
- Explicitly address ESG-related competence, expertise and skills in forthcoming guidance on pension fund board education.
- Require asset owners to prepare a public, annual report describing how they have integrated responsible investment into their investment policy statements, practices and processes, and their investment manager selection, appointment and monitoring processes.

The Code for Responsible Investing in South Africa (CRISA) Committee should strengthen oversight of the code by conducting more detailed analysis of current practice, analysing the investment and other outcomes that result from the code.

UNITED STATES:
The Department of Labor should:

- Clarify that fiduciary responsibility requires a long-term, risk-adjusted approach to management of pension assets so as to deliver sustainable retirement benefits to participants and beneficiaries in an impartial manner.
- Asset owners should pay attention to long-term factors (including ESG issues) in their decision-making, and in the decision-making of their agents.
- Asset owners are expected to proactively engage with the companies and other entities in which they are invested.
- And clarify that these actions are consistent with asset owners’ fiduciary duties.

- Reissue its 2008 bulletins on Economically Targeted Investments and on Shareholder Rights, and:
  - Clarify that asset owners’ duty is to impartially serve the interests of participants and beneficiaries.
  - Clarify that the assessment of the costs and benefits of risk management measures such as active ownership should explicitly consider the long-term benefits of such measures.
  - Clarify that green investments can make important financial and risk mitigation contributions to investment portfolios.
- Require asset owners to say how they integrate ESG issues into their investment decisions. As part of these requirements, the Department of Labor should commit to:
  - Review progress annually.
  - Explain how asset owners integrate ESG issues into their investment processes.
  - Analyse how these commitments have affected the actions taken and the outcomes achieved (where the outcomes relate to both investment performance and to the ESG performance of the entities in which they are invested).

The New York Stock Exchange (NYSE) and Nasdaq, given their scale and influence, should strengthen their ESG disclosure requirements for companies, in accordance with their public commitment to the Sustainable Stock Exchanges (SSE) initiative to promote long-term sustainable investment and improved ESG disclosure and performance among companies listed on their exchange.
COUNTRY ANALYSIS:
AUSTRALIA

119 PRI SIGNATORIES
34 ASSET OWNERS

THE AUSTRALIAN PENSION MARKET IN NUMBERS

Australia, total investment of pension funds (A$bn)10

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2006</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2007</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2008</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2009</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2010</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2011</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2012</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2013</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2014</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2015**</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

* Estimate
** March 2015
1 IMF, World Economic Outlook Database, 2015.
2 IMF, World Economic Outlook Database, 2015.
3 MF, World Economic Outlook Database, 2015.
4 MF, World Economic Outlook Database, 2015.
5 OECD: The total labour force, or currently active population, comprises all persons who fulfil the requirements for inclusion among the employed or the unemployed during a specified brief reference period.
7 OECD: Employment rate represent persons in employment as a percentage of the population of working age (15-64 years).
8 OECD, OECD Employment outlook 2015, Table B, 2015.
THE AUSTRALIAN INVESTMENT MARKET

Australia, home to the world’s fourth-largest private pension funds pool, has a three pillar pension system, comprising:

- A means-tested, tax-financed (i.e. non-contributory) public age pension that provides basic benefits.
- Compulsory (employer contributed) pension accounts.
- Voluntarily-funded individual pension accounts provided by superannuation funds and individuals’ self-managed funds.

Since 1992 Australian employers have been required to make superannuation contributions to a superannuation fund on behalf of each employee aged between 17 and 70 (subject to certain minimum earnings requirements). Employers who fail to do so, and who otherwise fail to provide membership of an equivalent defined benefit scheme, incur a ‘superannuation guarantee charge’.

The types of superannuation funds in Australia include self-managed funds (which have fewer than five members), industry funds and retail funds, which are offered to the public and to employers by financial service providers. Approximately one third of superannuation money is in self-managed funds and two-thirds in the 248 ‘large’ superannuation funds (i.e. APRA-regulated funds with more than five members). In fact, the superannuation market is highly concentrated with approximately half of the money in the large superannuation funds held in four large retail and the dozen largest industry and public sector funds, all of which have more than A$10 billion in assets under management.

Portability is a core principle of the Australian superannuation system, with members generally having the right to move assets between funds.

Australian superannuation funds tend to be heavily weighted towards domestic equities, resulting in them having large exposures to energy, resources and financial stocks.

---

11 Tower Watson, Global Pensions Asset study 2015, Global Pensions Asset Study 2014, Global Asset Pension Study 2013
LAW/POLICY CHANGES SINCE FRESHFIELDS (2005)

The legal framework for investment decision-making in Australia has not changed substantially since the Freshfields (2005) report. However, there have been a number of statutory and common law developments that reinforce, and in some cases raise, the standards of professional conduct expected of superannuation trustees and their boards.

Typically, the companies managing superannuation funds, life insurance statutory funds and managed investment schemes are established under the Corporations Act 2001 (Cth) (the Corporations Act). This means that the key decision makers are subject to directors’ duties, including:

- (a) exercising their powers and discharging their duties with the degree of care and diligence that a reasonable person would exercise if they were in that director or officer’s role,
- (b) exercising their powers and discharging their duties in good faith in the best interests of the corporation and for a proper purpose, and
- (c) not improperly using their position to gain an advantage for themselves or someone else or to cause detriment to the corporation.

Other requirements also apply depending on the type of fund involved. For non-self managed superannuation funds, these include:

- The terms of the superannuation trust deed.
- Trustee duties, in Section 52 of the Superannuation Industry (Supervision) Act 1993 (Cth) (SIS Act), to act honestly, to properly invest funds, to act in the best interests of the beneficiaries and to exercise a prescribed standard of care, skill and diligence and to give priority to beneficiaries where there is a conflict of interest. The trustee duties in section 52 are largely replicated in section 52A as covenants owed by the directors of the trustee, which the SIS Act implies into the trust deed.
- A duty in Section 29VN of the SIS Act to promote the financial interests of beneficiaries who hold MySuper products (simple, low-fee, default products for members who have not otherwise nominated an investment trust).

- The requirements of Section 62 of the SIS Act, which requires the fund to be maintained solely for the provision of benefits for each member of the fund on retirement (the ‘sole purpose test’).
- Prudential standards issued by the Australian Prudential Regulation Authority (APRA).

APRA and the Australian Securities and Investments Commission (ASIC) have published policy guides to support the mandatory requirements

The Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012 (the ‘Stronger Super’ reforms) amended the SIS Act to strengthen trustee duties in a number of ways. The changes included introducing the duty in Section 29VN to promote the financial interests of beneficiaries in relation to MySuper products (discussed above) and strengthening trustee competence requirements by increasing the standard of care, skill and diligence in Section 52(2)(b) from ‘ordinary prudent person’ to ‘prudent, professional superannuation trustee’. In addition to the heightened standard of due care and diligence for superannuation trustee directors, Australian courts have recently raised the expectations of corporate directors (which include the directors of superannuation trustees) in terms of the due diligence that they carry out, their knowledge and competence, and the actions that they take.

There has been some guidance from regulators on ESG issues. In November 2011 ASIC reissued Regulatory Guide 65 which requires product issuers to disclose whether and how labour standards and environmental, social or ethical considerations are taken into account for investment products. APRA’s Prudential Practice Guide on Investment Governance (SPG 530), issued in 2013, stated that a superannuation trustee may adopt an investment strategy that has an ESG focus, so long as it can demonstrate appropriate analysis to support its formulation (including being mindful of exposing the interests of beneficiaries to undue risk). However, this guidance is limited to the offer of ‘ethical investment options’, and classifies ESG factors as being ‘non-financial’.
PRACTITIONER PERSPECTIVES

Current Practice

Interviewees commented that there is a spectrum of views and practices in the Australian superannuation industry in relation to ESG issues. Some of the large asset owners are very proactive on responsible investment whereas others are not at all receptive.

Interviewees suggested that the strengthening of the trustee competence requirements to ‘prudent, professional superannuation trustee’ (in Section 52(2)(b) of the SIS Act) may strengthen the case for asset owners to focus on ESG issues. However, they also noted that there have been many other issues on the reform agenda for superannuation funds and regulators in recent years, including conflict management and funding requirements. These may have resulted in due diligence and ESG issues receiving less attention, at least to date, than might be suggested by the changes to the SIS Act.

Fiduciary Duty

In prescribing the ‘sole purpose’ as being to provide benefits to members upon their retirement, Section 62 of the SIS Act is widely accepted as precluding trustees from investing assets for other purposes such as bringing about social change.

“It is the process of information gathering and deliberation that is critical to satisfying the duty of due care and diligence. The decisions that result from that process are not the determinative issue. Rather, the question is whether, in their oversight of fund performance against its objectives, a trustee is appropriately informed and engaged, has sought expert advice where appropriate, has applied independent judgment to the matters at hand, and has constructively evaluated the strategic consequences of material issues using methodologies and assumptions that are appropriate for their forward-looking purpose.

In ESG and other long-term drivers of investment value, it means that trustees must explicitly engage with the impact of these financial risks and opportunities on their portfolios, and take actions that are appropriate in the context of the risks and opportunities presented by these issues.”

Sarah Barker (Special Counsel, Minter Ellison)

“One of the issues in the definition of best financial interests is timeframes – is it 3 years, 5 years, ‘long-term’? This is particularly important when deciding what to do about stranded assets and about issues that we know are important in the long-term but have relatively little effect on short-term financial performance.”

Danielle Press (CEO, EquipSuper)
This is reinforced by the traditional interpretation of the ‘best interests test’ as requiring trustees to exercise their functions and powers in the best financial interests of beneficiaries. This does not, however, prohibit ‘incidental advantages’ that may flow from properly considered and soundly-based investments. Interviewees were also clear that the best interests test cannot be considered without reference to risks posed to the fund and its investments by ESG issues, although they acknowledged that there is a lack of clarity around the extent to which best financial interests requires asset owners to take account of ESG issues in their investment processes. There is also a lack of clarity on the timeframes over which these interests are to be assessed, other than the general expectation that investors would be expected to account for beneficiaries’ proximity to retirement.

In practice, this lack of clarity has resulted in a wide range of interpretations being adopted by market participants. Many see ESG issues as consistent with value creation, particularly over long-term time horizons, and therefore see that their fiduciary duty requires them to take a proactive approach to responsible investment. Conversely, others prioritise short/medium term investment returns and/or see ESG issues as ‘non-financial’.

From a legal perspective, fiduciary duties are widely considered to be proscriptive, rather than prescriptive, principles. That is, they are procedural and purposive requirements, rather than obligations to achieve particular beneficial outcomes. In practice, conduct must be directed towards beneficiaries’ best interests, and due process and competence must be applied in decision making. This is likely to require trustees to show that they have identified and assessed ESG-related risks to companies and to their portfolios, to have adopted specific measures to manage these risks, and to have interrogated and challenged company management.

Finally, it is important that the actions taken are clearly linked to drivers of investment value. Interviewees cited the recent examples of ANU and HESTA’s decisions to divest from or exclude certain fossil fuel assets from their investment portfolios. They noted that ANU was publicly criticised by many financial commentators – and some senior politicians, including the Prime Minister – for its decision to divest its holdings in seven domestic resources companies on the basis of their ‘ESG ratings’. In contrast, HESTA’s decision, which referenced long-term risk management and members’ best interests, to exclude new investment in thermal coal assets received little adverse commentary.

APRA’s role includes ensuring that superannuation funds have appropriate investment strategies, that they implement these strategies appropriately and that they ensure that benefits are distributed to members in an equitable manner.

Our interview with APRA provided some interesting insights into how it sees ESG issues in the context of fiduciary duty.

APRA noted that it generally gives funds the freedom to decide how they wish to take account of ESG issues in their investment practices and processes. Within this, APRA’s view is that superannuation funds should be aware of and manage ESG-related risks while also being careful of decisions that lead to skews in portfolios.

In relation to negative screens, APRA commented that such screens, so long as they are relatively limited in number, are generally unlikely to result in an unreasonable portfolio or override overall portfolio construction processes. While APRA accepts that individuals will consider ethical positions, all investments and investment strategies must be based on financial considerations. APRA also commented that funds that adopt negative screens would be expected to take account of risk-return trade-offs, of the need for diversification and of portfolio characteristics.

In relation to issues such as stranded assets - or, more generally, situations where a fund decides not to invest in a particular sector or asset class on the basis of a long-term macroeconomic driver - APRA acknowledged that there is often a strong investment rationale for such decisions. However, it stressed that where superannuation funds take decisions that expose them to specific risks (e.g. a high carbon portfolio, a portfolio with a weighting to renewable energy), APRA will generally expect them to explicitly stress test the investment risks associated with these decisions.

Finally, APRA noted that positive screens could run counter to the ‘sole purpose’ test, and could result in asset owners not building efficient or diversified portfolios.
Drivers for Action

Asset owners are paying increasing attention to ESG issues in their investment processes and in their dialogue with companies. The reasons include:

- The establishment of the Australian Council of Superannuation Investors (ACSI) by a number of superannuation funds and industry bodies to develop guidelines for superannuation funds on ESG issues and to establish corporate governance principles for Australian-listed companies.
- The Establishment of the ASX Corporate Governance Council.
- The Financial Service Council’s (FSC) standards on voting disclosure and ESG risk reporting.
- Guidance from bodies such as the Australian Institute of Superannuation Trustees on the integration of ESG issues into decision-making.
- NGO campaigns on specific issues, with a number of these (e.g. on stranded assets) raising significant investment concerns, which are increasingly being echoed by leading Australian brokers, consultants and advisors (such as Citi, HSBC and Mercer).
- The likelihood that the industry will face increased demands for transparency (e.g. in relation to fund holdings).
- Industry competition for members with responsible investment being a potential point of differentiation.
- Growing consumer interest in ethical and green funds.
- Growing recognition by fund managers that ESG issues – in particular, governance issues – are important and need to be accounted for in investment decision-making.
- Growing recognition that responsible investment may enable above benchmark returns to be achieved.

Barriers to Progress

Interviewees identified a number of reasons why trustees do not account for ESG issues in their investment practices and processes:

- Entrenched ‘short-termism’, driven by factors such as fund manager remuneration structures and performance/reporting cycles.
- Ambiguous legal rules, in particular the absence of case law on the extent to which the duty to maximise benefits for beneficiaries may be viewed as inconsistent with ESG investment, and on the practical import of the heightened standard of trustee due diligence.
- The limited guidance from APRA on how responsible investment should be applied in practice, raising concerns that responsible investment may run counter to trustees’ fiduciary duties.
- Historical trust instruments. The fact that the trust deeds of many of the large investment funds in Australia were settled at least 20 years ago and do not contemplate ESG investment is seen as increasing the risk for funds that they may not have the legal power to make ESG investments.
- The need for liquidity, diversification and dividend yield, which has, historically, been a very important argument for investing in the resources and energy sector. This is compounded by a commonly held view that responsible investment is the same as negative screening.

RECOMMENDATIONS

In addition to the global recommendations, we recommend that:

The Australian Prudential Regulation Authority (APRA) should clarify that fiduciary duty requires asset owners to pay attention to long-term factors (including ESG factors) in their decision-making, and in the decision-making of their agents.

Australian regulators should clarify that responsible investment includes ESG integration, engagement, voting and public policy engagement.
COUNTRY ANALYSIS:
BRAZIL

62 PRI SIGNATORIES
17 ASSET OWNERS

THE BRAZILIAN PENSION MARKET IN NUMBERS

Brazil, total investment of pension funds (R$bn)\(^{21}\)

\begin{tabular}{|c|c|c|c|c|}
\hline
\textbf{Year} & 2012 & 2013 & 2014 & 2015* \\
\hline
\textbf{NOMINAL GDP (Sbn)\(^{12}\)} & 2,412 & 2,391 & 2,353 & 1,904 \\
\textbf{NOMINAL GDP (R$bn)\(^{13}\)} & 4,713 & 5,157 & 5,521 & 5,954 \\
\textbf{POPULATION (million)\(^{14}\)} & 199.2 & 201.0 & 202.7 & 204.4 \\
\textbf{GDP PER CAPITA (R$/capita)\(^{15}\)} & 23,655 & 25,655 & 27,229 & 28,124 \\
\textbf{LABOUR FORCE (million)\(^{17}\)} & 104.7 & 106.1 & 107.3 & -- \\
\textbf{EMPLOYMENT RATE\(^{19}\)} & -- & -- & 64.7% & -- \\
\textbf{% POPULATION > 65\(^{20}\)} & 7% & 8% & 8% & -- \\
\hline
\end{tabular}

\* Estimate

\** April 2015

12 IMF, World Economic Outlook Database, 2015.
14 IMF, World Economic Outlook Database, 2015.
16 OECD: The total labour force, or currently active population, comprises all persons who fulfill the requirements for inclusion among the employed or the unemployed during a specified brief reference period.
17 WB Data, Labor force total, 2015.
18 OECD: Employment rate represent persons in employment as a percentage of the population of working age (15-64 years).
20 WB Data, Population ages 65 and above (% of total), 2015.
THE BRAZILIAN INVESTMENT MARKET

The Brazilian stock exchange BM&FBOVESPA is the largest exchange in Latin America and one of the largest in the world with a market capitalization of over US$800 billion.

The Brazilian pension system comprises three pay-as-you-go pillars:
- the public mandatory system known as the General Social Security Regime (RGPS);
- the Pension Regimes for Government Workers (RPPS);
- the Private Pension Regime (RPC), which covers occupational and individual plans (referred to as ‘closed entities’ and ‘open entities’ respectively). The largest closed pension entities are Previ, Petros and Funcef.

Closed pension funds are regulated by the National Regulatory Board for Complementary Pensions (Conselho Nacional de Previdência Complementar (CNPC)) and open pension entities by the Superintendence of Private Insurance (SUSEP). The National Superintendence of Complementary Pensions (PREVIC) supervises closed funds in relation to, amongst other areas, governance, disclosure, investments and fees.

LAW/POLICY CHANGES SINCE FRESHFIELDS (2005)

Brazil was not covered by the original Freshfields report in 2005.

Since 2005, the most significant regulatory change has been Resolution 3.792, issued in 2009 by the Brazilian Monetary Council (Conselho Monetario Nacional (CMN)). The Resolution requires closed pension funds to use due diligence, to comply with the law and to adopt high ethical standards when making investments. The resolution also requires closed pension funds to comply with several governance requirements, one of which is that they must state whether they take account of environmental and social issues

---

Brazil, % AUM by type of pension scheme

<table>
<thead>
<tr>
<th>Year</th>
<th>Defined benefit</th>
<th>Defined contribution</th>
<th>Variable contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>74%</td>
<td>10%</td>
<td>16%</td>
</tr>
<tr>
<td>2013</td>
<td>75%</td>
<td>9%</td>
<td>16%</td>
</tr>
<tr>
<td>2014</td>
<td>73%</td>
<td>10%</td>
<td>17%</td>
</tr>
</tbody>
</table>
in their investment practices. PREVIC requires pension funds to explicitly state in their annual statements whether they comply with the environmental and social aspects of Resolution 3.792.

PRACTITIONER PERSPECTIVES

Investment Practice
Interviewees commented that, at this point, relatively few Brazilian asset owners are active on responsible investment. The exceptions are some of the larger pension funds and investment managers, many of whom are PRI signatories. These organisations tend to have ESG policies and to integrate these issues, in particular corporate governance, into their investment practices and processes.

“Governance requirements are stressed in Resolution CMN No. 3.792. In addition, PREVIC has developed a series of Best Practice Guides (Actuarial, Investment, Accounting, Governance) that have helped pension funds and investment managers to improve their governance practices. We intend to strengthen the coverage of environmental and social issues when we update these Guides.”

Marcelo Seraphim (Pension Fund Specialist, PREVIC)

Interviewees contrasted the regulatory requirements for investment management with those for project financing. Of particular relevance to current investment practice is the fact that, in project financing, banks have some responsibilities – albeit not the primary responsibility – for the activities that they finance. Some interviewees commented that one of the reasons why institutional investors have been less active on environmental and social issues is the concern that they could be held liable for the impacts of the companies in which they invest.

Fiduciary Duty
Brazil is a civil law country. The fiduciary duties of institutional investors are defined in legislation and in the guidance and other materials issued by relevant government agencies. These are supplemented by regulations and codes created by market players.

The Brazilian Federal Constitution states that private property and the economic and social order shall ensure social welfare, and that environmental protection is a duty of the government and society. Within this, the government, individuals, corporations, financial institutions and other entities all have a social role that is guided by principles of environmental protection and public welfare. Furthermore, the Brazilian Corporations Law (Law Nr. 6,404/1976) has established fiduciary duties for the controlling shareholder (or shareholders) in a company, requiring them to exercise their shareholding power to promote the social well-being of the other shareholders and of the community. This law applies to all privately and publicly held corporations organised and headquartered in Brazil.

The Brazilian securities market is regulated by the Comissão de Valores Mobiliários (CVM), a federal agency. CVM issues different types of regulations, the most important of which is the Instrução (a normative instruction). Once an Instrução comes into force, it becomes the binding and enforceable regulation for the particular subject matter in question.
The managers of third party assets in Brazil are bound by strong regulatory requirements in relation to managing conflicts of interest and fair dealing. For example, Instrução 306 (issued by CVM in 1999) states that investment managers should refrain from taking any action that may breach the fiduciary duty that they owe to their clients. Among the specific requirements of this Instrução are that investment managers should disclose potential conflicts of interest and should perform their activities using all the care and diligence that an active and honest person would use when managing his or her own business.

In relation to self-regulation, Associação Brasileira de Entidades dos Mercados Financeiros e de Capitais (ANBIMA, the Brazilian Financial and Capital Markets Association) is recognised as a self-regulatory body by the relevant regulatory authorities. This means that ANBIMA has an independent role in relation to the development, enforcement and monitoring of its self-regulatory standards. ANBIMA has issued a Code of Regulation and Best Practices for Investment Funds. The Code applies to the over 300 investment managers and the investment consultants associated with ANBIMA, as well as those organisations that, even though not associated, choose to be bound by the Code.

“The market requirements imposed on institutional investors are, in many ways, even stronger than those imposed by legislation. Furthermore, they have real effect; back office administrators will not work with fund managers that do not comply with ANBIMA’s rules.”

Luciana Burr (Partner, Rayes & Fagundes)

“Extract from the ANBIMA Code of Regulation and Best Practices for Investment Funds

“Article 6 - Participating Institutions shall observe, within the ambit of their functions and responsibilities to the Investment Funds, the following regulation and best practices rules:

I. Perform their activities by endeavouring to meet the objectives set out in the Investment Fund’s rules and prospectus, if applicable, as well as to promote and disclose the information related thereto in a transparent manner, including compensation for their services, always towards enabling an easy and accurate understanding thereof by investors;

II. Comply with all its obligations upon development of their activities, by exercising the ordinary care that every diligent person exercises in the management of his or her own business, and by agreeing to be liable for any breach or irregularity that may be committed during the period in which they provide any services under Paragraph 1 of Article 2 hereof;

III. Avoid practices that might harm the fiduciary relationship that exists between the shareholders of the Investment Funds; and

IV. Avoid practices that might adversely affect the Investment Funds industry and its agents, especially as regards the rights and duties relative to each Participating Institution’s functions under the agreements, regulations and the prevailing legislation.”

“The market requirements imposed on institutional investors are, in many ways, even stronger than those imposed by legislation. Furthermore, they have real effect; back office administrators will not work with fund managers that do not comply with ANBIMA’s rules.”

Luciana Burr (Partner, Rayes & Fagundes)

“Extract from the ANBIMA Code of Regulation and Best Practices for Investment Funds

“Article 6 - Participating Institutions shall observe, within the ambit of their functions and responsibilities to the Investment Funds, the following regulation and best practices rules:

I. Perform their activities by endeavouring to meet the objectives set out in the Investment Fund’s rules and prospectus, if applicable, as well as to promote and disclose the information related thereto in a transparent manner, including compensation for their services, always towards enabling an easy and accurate understanding thereof by investors;

II. Comply with all its obligations upon development of their activities, by exercising the ordinary care that every diligent person exercises in the management of his or her own business, and by agreeing to be liable for any breach or irregularity that may be committed during the period in which they provide any services under Paragraph 1 of Article 2 hereof;

III. Avoid practices that might harm the fiduciary relationship that exists between the shareholders of the Investment Funds; and

IV. Avoid practices that might adversely affect the Investment Funds industry and its agents, especially as regards the rights and duties relative to each Participating Institution’s functions under the agreements, regulations and the prevailing legislation.”

“Sole Paragraph - A fiduciary relationship is so considered the relationship involving trust and loyalty between the shareholders of the Investment Funds and the Participating Institution, from the moment this latter is entrusted with the services to be performed by it.”
Interviewees commented that the lack of attention paid in regulations and in codes to ESG-related issues or to responsible investment more generally is one of the reasons why Brazil’s approach to responsible investment is not as advanced as in other markets. This is starting to change: for example, ANBIMA is considering introducing social issues into its guidance on due diligence. This change is, in part at least, in response to demand from asset owners.

Potential Drivers of Change

The Brazilian investment industry is at a relatively early stage in the adoption of ESG integration and long-term responsible investment. Interviewees pointed to a number of potential drivers of change:

- Foreign investors concerned about the social or environmental performance of the companies they invest in. This may lead to investors calling for some form of stewardship code where investors work together to raise the social and environmental performance of companies.

- The growing awareness of the investment implications of social and environmental issues such as access to water, child labour and workers’ rights. One interviewee commented that environmental issues may start to receive greater attention in coming years as Brazilian regulatory authorities start to pay greater attention to the effective enforcement of environmental legislation.

- The PRI interviewees suggested that the PRI could play an important role in catalysing changes through building market awareness of ESG integration, through setting out and communicating the investment case for investors to focus on ESG issues in their investment practices and processes, and through encouraging large asset owners to become signatories (and, in turn, exerting pressure on other investment industry actors).

- The reputational concerns of wealth managers and asset owners. These institutional investors want to ensure that they do not invest in companies that have corruption issues and have started to push their investment managers to look closely at these issues when making investments.

“ANBIMA is currently trying to introduce requirements on social issues such as slave or bonded labour into its guidance on investment due diligence. One of the obstacles to progress is that asset managers are concerned about their liability for these issues. That is, what might happen if their due diligence fails to identify relevant issues, or if they do identify issues but do not take effective action? Brazilian legislation is not clear on who is responsible when social issues are identified. This need for regulatory certainty is a key determinant of the progress that will be made.”

José Carlos Doherty (Chief Executive Officer, ANBIMA)
Barriers and Challenges
Interviewees identified a number of distinct barriers to progress:

- The absence of regulatory or self-regulatory requirements for investors to focus on ESG issues in their investment practices and processes.
- Weaknesses in the implementation and oversight of Resolution 3.792, specifically that there is no analysis of how the environmental and social requirements of the Resolution have influenced investment practice.
- Weaknesses and inconsistencies in corporate reporting on environmental and social issues. This makes it difficult for investors to take account of these issues in their investment processes.
- The perception that responsible investment may limit investors’ investment universe and have a negative impact on investment performance.

RECOMMENDATIONS
In addition to the global recommendations, we recommend that:

Comissão de Valores Mobiliários (CVM) and Associação Brasileira das Entidades dos Mercados Financeiro e de Capitais (ANBIMA) should, for asset owners and investment managers respectively:

- clarify that fiduciary duty requires them to pay attention to long-term factors (including ESG factors) in their decision-making, and in the decision-making of their agents;
- clarify that they are expected to take account of ESG issues in their investment processes and decision-making, and to proactively engage with the companies and other entities in which they are invested.

Superintendência Nacional de Previdência Complementar (Previc) should strengthen its oversight and implementation of Resolution 3.792 by analysing and reporting on the implementation of the environmental and social issues requirements of Resolution 3.792 and its effect on investor practice and performance.

“As yet, there has been limited regulatory/policy pressure for investors to focus on ESG issues/responsible investment in their investment processes. This is unlikely to change in the near term. However, longer-term we may see developments similar to those seen in Europe (in terms of regulators expecting investors to play a more active ownership role).”

Mario Fleck (CEO, Rio Bravo Investimentos)
COUNTRY ANALYSIS:

CANADA

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015*</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOMINAL GDP (Sbn)23</td>
<td>1,832</td>
<td>1,839</td>
<td>1,788</td>
<td>1,615</td>
</tr>
<tr>
<td>NOMINAL GDP (C$bn)24</td>
<td>1,831</td>
<td>1,893</td>
<td>1,976</td>
<td>2,015</td>
</tr>
<tr>
<td>POPULATION (million)25</td>
<td>34.7</td>
<td>35.1</td>
<td>35.5</td>
<td>35.8</td>
</tr>
<tr>
<td>GDP PER CAPITA (C$/capita)26</td>
<td>52,775</td>
<td>53,953</td>
<td>55,681</td>
<td>56,181</td>
</tr>
<tr>
<td>LABOUR FORCE (million)27</td>
<td>18.80</td>
<td>19.03</td>
<td>19.12</td>
<td>19.20</td>
</tr>
<tr>
<td>EMPLOYMENT RATE30</td>
<td>72.0%</td>
<td>72.4%</td>
<td>72.3%</td>
<td>--</td>
</tr>
<tr>
<td>% POPULATION &gt; 6531</td>
<td>14.9%</td>
<td>15%</td>
<td>15.7%</td>
<td>16%</td>
</tr>
</tbody>
</table>

THE CANADIAN PENSION MARKET IN NUMBERS

Canada, total investment of pension funds (C$bn)32

---

23 IMF, World Economic Outlook, 2015.
24 IMF, World Economic Outlook, 2015.
25 IMF, World Economic Outlook, 2015.
26 IMF, World Economic Outlook, 2015.
27 OECD: The total labour force, or currently active population, comprises all persons who fulfill the requirements for inclusion among the employed or the unemployed during a specified brief reference period.
29 OECD: Employment rate represent persons in employment as a percentage of the population of working age (15-64 years).
30 OECD, Employment rate, 2015.
31 The World Bank Data, Population ages 65 and above (% of total), 2015.
32 OECD, Pension Market in Focus 2014, table 4 and OECD, Pension Funds in Figures, 2015.
THE CANADIAN INVESTMENT MARKET
Canada’s financial services sector accounts for between 6% and 8% of Canadian GDP. The financial capital is Toronto, home to the Toronto Stock Exchange.

Canada’s pension system is characterised by a mixture of public and private pension schemes. The Old Age Security programme and the income-tested Guaranteed Income Supplement provide flat rate pensions paid through general taxation and are available to most people 65 and older. Workers and employers (including the self-employed) must also contribute to the Canada Pension Plan which provides an earnings-related pension.

Employers may also provide pension arrangements, with the coverage of these being much higher in the public than the private sector. These can be defined benefit, defined contribution (which is increasingly common, in particular in the private sector) or hybrid. There are also individual retirement savings plans that have preferential tax treatment (e.g. RRSP).

The Office of the Superintendent of Financial Institutions (OSFI) is an independent agency of the Government of Canada, established in 1987 to contribute to the safety and soundness of the Canadian financial system. OSFI supervises and regulates federally registered banks and insurers, trust and loan companies, as well as private pension plans subject to federal oversight. Approximately 6% of private pension plans in Canada are federally regulated; these are pension plans for employees and beneficiaries in federally regulated areas of employment, such as banking, inter-provincial transportation and telecommunications. Pension plans in Canada’s three territories (the Yukon, the Northwest Territories and Nunavut) are also regulated by OSFI.

33 Statistics Canada, Table 280-0014 - Registered pension plans (RPPs), members and market value of assets, by funding instrument, sector, type of plan and contributory status, annual, CANSIM (database), 2014.
Beyond federally regulated pension plans, the Canadian provinces are responsible for pension regulation and supervision. The key bodies in each province — acknowledging that their specific powers vary from province to province and federally — are:

- Alberta: Alberta Treasury Board and Finance
- British Columbia: Financial Institutions Commission
- Manitoba: Pension Commission
- New Brunswick: Financial and Consumer Services Commission
- Nova Scotia: Department of Environment and Labour
- Newfoundland and Labrador: Service Newfoundland and Labrador
- Ontario: Financial Services Commission of Ontario
- Québec: Régie des rentes du Québec
- Saskatchewan: Financial and Consumer Affairs Authority of Saskatchewan

**LAW/POLICY CHANGES SINCE FRESHFIELDS (2005)**

At the federal level there have been no changes in legislation relating to responsible investment since the Freshfields report was issued in 2005.

There are two relevant developments at the provincial level. The first is that, as noted in the 2005 Freshfields report, Manitoba’s pension standards legislation (2005) allows ESG factors to be taken into account so long as investment policy and decision making remain consistent with prudence standards.

The second is that Ontario’s pension standards legislation (PBA909) will, starting in 2016, require pension funds to disclose in their investment policies ‘information about whether environmental, social and governance factors are incorporated into the plan’s investment policies and procedures and, if so, how those factors are incorporated’.

**PRACTITIONER PERSPECTIVES**

**Current Practice**

The interviewees for this project commented that Canada’s large statutory and public sector pension plans (e.g. CPPIB, bcIMC, OTPP) have been active on long-term responsible investment, in particular on corporate governance issues. However, there was also a sense that Canadian asset owners lag behind their European counterparts, both in relation to the level of attention paid to environmental and social issues and in relation to the monitoring and oversight of their investment managers’ activities on responsible investment.

Similar comments were made about investment managers. Interviewees commented that investment managers, in particular the larger organisations, do take corporate governance issues into account in their investment processes, do vote their shareholdings and do carry out some engagement on corporate governance, individually or through collaborative initiatives such as the Canadian Coalition for Good Governance (CCGG). However, as with asset owners, much less attention is paid to environmental and social issues.

Interviewees suggested that investment managers’ activity on responsible investment depends on two factors. The first is their client base. Those with a significant number of European clients are more likely to adopt a proactive approach. The second is their size. Most of the local investment management firms have relatively small research teams. This, in the absence of strong client demand or specific mandates, limits the amount of work they can do on responsible investment and the level of attention they can pay to ESG issues in their investment research.

The heavy dependence of the Canadian economy on the extractives sector (in particular oil sands) is an important influence on how Canadian investors look at climate change. Interviewees commented that while most Canadian asset owners oppose calls for divestment, they are interested in data and information that enables them to respond appropriately to calls for divestment. At present, those Canadian asset owners that are assessing climate change risks appear particularly interested in measuring their carbon footprints and using this information to slowly transition to lower carbon alternatives over time.
Fiduciary Duty

The legal obligations on asset owners in Canada are derived from several sources, including the scheme’s own foundation documents (e.g. the plan text and funding agreement), common law duties (in jurisdictions outside of Quebec), pension standards legislation, and income tax requirements. Pension standards legislation and the common law impose a fiduciary duty. The general fiduciary duties include a duty of loyalty to beneficiaries, as well as adherence to the standard of care of a prudent person.

"Fiduciary duty is a process test. That is, it requires trustees to look at the range of issues that may affect performance over the short and long-term, to look at how these issues may translate into financial impact, and based on this analysis, to decide how to manage these issues.”

Karen Lockridge (Pension Actuary, Mercer)

"In DC schemes, it is workers and savers that bear the risk. It is, therefore, essential that all risks (that obviously includes asset diversification, but ESG factors as well) are properly managed. This is the starting point for defining responsibility in a DC scheme.”

Daniel Simard (CEO, Bâtirente)

Interviewees stressed the importance of fiduciary duty as an influence on asset owners’ investment practices and approach to responsible investment. While the specific duties depend on the organisation’s mission (e.g. to maximise risk-adjusted returns, to deliver on the organisation’s pension’s promise), in practice fiduciary duty is interpreted as meaning that asset owners need to focus primarily on the short-term financial interests of their beneficiaries. This emphasis on relatively narrowly drawn financial interests tends to be reinforced by the advice provided by legal advisers and investment consultants to asset owners.

Drivers for Change

Interviewees commented that while the emphasis on financial returns is a constraint, it does not prevent organisations from taking a longer-term approach (e.g. in terms of how they define their investment goals), from considering ESG issues in their investment research and decision-making (so long as there is a clear focus on the financial implications of these issues) or from engaging with companies or policymakers on ESG issues. They pointed to the activities of some of the larger Canadian pension funds (e.g. CPPIB, bcIMC, OTPP) as evidence of the potential for asset owners to adopt a wider and more long-term approach. Some also noted that the systematic adoption and implementation of responsible investment is hindered by the lack of regulatory guidance or court decisions on how it aligns with fiduciary duty.

• Growing awareness of the potential investment value resulting from a focus on ESG issues.
• Market demand. That many of the largest asset owners in Canada have now signed the PRI was identified as a particularly important signal about the importance of responsible investment to asset owners.
• PRI reporting requirements. Signatories to the PRI commented that the PRI reporting requirements and the fact that these reports are made publicly available has meant that they have needed to strengthen their systems and processes.
“The ideas of intergenerational equity (in the context of the long term investment objectives of pension funds) may result in a broadening of the scope of pension fund trustees’ fiduciary duties.”

Ed Waitzer (Partner, Stikeman Elliott)

• Regulatory change. Interviewees pointed to Ontario’s pension standards legislation as having a catalytic effect. It has resulted in pension fund administrators – both within Ontario and elsewhere in Canada – having explicit conversations about ESG issues, and seeking advice from their consultants and legal advisers on modern interpretations of fiduciary duty.

• International practices. Interviewees commented that Canadian investors tend to evaluate themselves against leading European investment organisations, and often look to Europe for ideas on how they might strengthen their approach to responsible investment.

“Over the past 12 months, we have seen an increase in client and consultant interest in responsible investment, in both the US and Canada. Consultants are asking deeper questions and larger clients are interested in ESG integration and in how ESG analysis is used to identify risks and opportunities and to engage with companies.”

Judy Cotte (VP and Head, Corporate Governance and Responsible Investment, RBC Global Asset Management)

Barriers to Progress

Interviewees pointed to a number of distinct barriers to progress:

• The lack of regulatory guidance or court decisions on how responsible investment aligns with fiduciary duty. Some interviewees pointed to the value of having clarity on timeframes (or the definition of ‘long-term’), the specific activities that should form part of investors’ approach to responsible investment, and the issues that should be considered in investment research and decision-making processes.

• Legal advisers and investment consultants continuing to argue for very narrow interpretations of fiduciary duty, perhaps in part because of the lack of explicit guidance. This has acted as a brake on asset owners’ willingness to adopt responsible investment.

• The lack of robust evidence on the relationship between environmental and social issues and investment performance. Interviewees commented that this contrasts with corporate governance where there is good academic research on the investment relevance of these issues, and there has been legal clarification (e.g. in the Enron case, in the SEC decisions about the rating agencies) of governance expectations.

• The weaknesses and inconsistencies in corporate reporting on environmental and social issues. This makes it difficult for investors to take account of these issues in their investment processes.

• Many trustees continuing to equate responsible investment with negative screening and thereby limiting their investment universe with consequent negative effects on investment performance.

• The relatively small number of individuals in Canada with deep expertise in areas such as ESG integration and active ownership. Some interviewees commented that this capacity is primarily a function of market demand. They suggested that, if general market demand was stronger and the investment case for responsible investment clearer, any capacity gaps would probably be addressed relatively quickly.
RECOMMENDATIONS
In addition to the global recommendations, we recommend that:

The Office of the Superintendent of Financial Institutions and the relevant pension regulators in each province should clarify that asset owners are expected to pay attention to long-term factors (including ESG factors) in their decision-making, and in the decision-making of their agents.

The federal government and the governments of the provinces should follow the example set by Ontario and introduce ESG disclosure legislation. The legislation should require regulators to:

- Review progress annually.
- Explain how asset owners integrate ESG issues into their investment processes.
- Analyse how these commitments have affected the actions taken and the outcomes achieved (where the outcomes relate to both investment performance and to the ESG performance of the entities in which they are invested).
COUNTRY ANALYSIS: EUROPEAN UNION

As members of the European Union (EU), both the UK and Germany are subject to and influenced by the legal regime and decisions of EU institutions.

The Occupational Pensions Directive

In relation to fiduciary duty, the most significant piece of European legislation has been the 2003 Directive on the Activities and Supervision of Institutions for Occupational Retirement Provision (the Occupational Pensions Directive). The Directive applies to institutions for occupational retirement provision (IORPs) – essentially, private sector occupational pension schemes. IORPs are expected to invest in accordance with the ‘prudent person’ rule, and to ensure that:

- Assets are invested in the best interests of members and beneficiaries (or, in cases of a conflict of interest, in the sole interest of the members and beneficiaries).
- Assets are invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole, and are invested in a manner appropriate to the nature and duration of the expected future retirement benefits.
- Assets are properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings and accumulations of risk in the portfolio as a whole.

IORPs are also expected to draw up and, at least every three years, review a statement of investment policy principles (SIP). The SIP should be made available to the competent authorities and, on request, to the members and beneficiaries of each pension scheme. There is no requirement to explicitly reference ESG considerations in these SIPs.

Recent developments

Beyond the Occupation Pensions Directive, a number of other EU Directives are relevant to how investors implement their fiduciary duties and wider commitments to responsible investment. These include:

- Directive 2014/95/EU on the Disclosure of Non-Financial and Diversity Information by Certain Large Undertakings and Groups (widely referred to as the Non-Financial Reporting Directive), which requires companies with more than 500 employees to disclose information on their policies, risks and outcomes as regards environmental matters, social and employee issues, human rights, anti-corruption, bribery and board diversity.
- Directive 2007/36/EC on the Exercise of Certain Rights of Shareholders in Listed Companies (commonly referred to as the Shareholder Rights Directive) which sets out minimum standards to ensure that shareholders have timely access to relevant information ahead of general meetings and are able to vote their holdings electronically. It also abolishes share blocking and introduces minimum standards for the rights to ask questions, to put items on the agenda of shareholder meetings and to table resolutions.
- Directive 2014/65/EU on Markets in Financial Instruments (MiFID 2) – repealing Directive 2004/39/EC on Markets in Financial Instruments Directive (MiFID 1) – and Regulation 600/2014 on Markets in Financial Instruments (MiFIR) which aim to make financial markets more efficient, resilient and transparent by ensuring that trading, wherever appropriate, takes place on regulated platforms, by introducing rules on high frequency trading, by improving the transparency and oversight of financial markets, and by introducing robust organisational and conduct requirements.

“As a Dutch pension fund investor APG is required to integrate ESG factors across all its asset classes and investment processes as part and parcel of what it does. It is core to our pension fund investing proposition.”

Claudia Kruse (Managing Director, Head of Governance & Sustainability, APG)
Potential future developments

One of the recurring themes in our interviews with European-based practitioners is that changes to European Union legislation are likely to have an important influence on investment practice and on the definitions and interpretations of fiduciary duty. The changes that are currently (August 2015) under discussion include:

- Mobilising personal pension savings to support long-term investment in the real economy.
- Launching the EU’s wider Capital Markets Union initiative to make investment markets work more effectively.
- Requiring, as part of the proposed revisions to the Shareholder Rights Directive, institutional investors to disclose how they cast their votes at company general meetings, and publish a policy on shareholder engagement, which includes details of how shareholder engagement is integrated in their investment strategy, how investee companies are monitored and engaged with, how collective engagement is used and how conflicts of interest are managed.
- Requiring, as part of the proposed revisions to the Occupational Pensions Directive, IORPs to (a) improve their risk management so that potential vulnerabilities in relation to the sustainability of the pension scheme can be properly understood and discussed with the competent authorities, (b) include consideration of new or emerging risks (e.g. climate change) in their risk evaluations, and (c) ensure that members or beneficiaries are informed about how environmental, climate, social and corporate governance issues are considered in the investment approach.

- Encourage Member States to ensure that fiduciary duty and responsible investment-related legislation is harmonised and consistent across Europe.
- Encourage Member States to monitor the implementation of legislation and other policy measures relating to fiduciary duty and responsible investment, and report on the investment and other outcomes that result.

European Commission study on fiduciary duty

In Autumn 2015, the European Commission’s Directorate-General for the Environment, will publish a report, authored by Ernst & Young, titled Resource Efficiency and Fiduciary Duties of Investors. The report’s aim is to provide clarification and policy advice on the integration of environmental and resource efficiency issues into fiduciary duties in the European Union. The report will review the state of fiduciary duties at EU level and, in more depth, in five selected Member States. Based on this analysis, it will develop recommendations on whether environmental and resource efficiency issues should be taken into account proactively in fiduciary duties and indicate concrete steps at EU and Member State level to achieve such integration.

RECOMMENDATIONS

In addition to the global recommendations, we recommend that:

- The European Commission should provide guidance to the competent Member States authorities on how they should interpret fiduciary duty in the national legal context. This guidance should:
  - Clarify that fiduciary duty requires asset owners to pay attention to long-term factors (including ESG factors) in their decision-making and in the decision-making of their agents.
  - Clarify that responsible investment includes ESG integration, engagement, voting and public policy engagement.
COUNTRY ANALYSIS: GERMANY

THE GERMAN PENSION MARKET IN NUMBERS

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015*</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOMINAL GDP (€bn)</td>
<td>3,535</td>
<td>3,731</td>
<td>3,859</td>
<td>3,413</td>
</tr>
<tr>
<td>GDP PER CAPITA (€/capita)</td>
<td>80.5</td>
<td>80.7</td>
<td>81.1</td>
<td>81.3</td>
</tr>
<tr>
<td>LABOUR FORCE (million)</td>
<td>34,150</td>
<td>34,784</td>
<td>35,805</td>
<td>37,061</td>
</tr>
<tr>
<td>EMPLOYMENT RATE (%)</td>
<td>72.7%</td>
<td>73.5%</td>
<td>73.8%</td>
<td>74.3%</td>
</tr>
<tr>
<td>% POPULATION &gt; 65%</td>
<td>20.6%</td>
<td>20.7%</td>
<td>20.8%</td>
<td>21.6%</td>
</tr>
</tbody>
</table>

Germany, total investment of pension funds (€bn)

---

* Estimate
** Preliminary data
34 IMF, World Economic Outlook, 2015.
35 IMF, World Economic Outlook, 2015.
36 IMF, World Economic Outlook, 2015.
37 IMF, World Economic Outlook, 2015.
38 OECD: the total labour force, or currently active population, comprises all persons who fulfill the requirements for inclusion among the employed or the unemployed during a specified brief reference period.
40 OECD: Employment rate represent persons in employment as a percentage of the population of working age (15-64 years).
43 Eurostat, proportion of population aged 65 and over, 2015.
45 OECD, Pension Market in Focus 2014, table 4 and OECD, Pension Funds in Figures, 2015.
The German Investment Market

Historically, Germans relied predominantly on the pension benefits provided by statutory pension insurance. This is beginning to change and the German public pay-as-you-go system is increasingly being supplemented by private systems.

German employers can choose between as many as five different methods of financing and organising pension schemes. These are:

- Direct pension promises, usually funded via book-reserve accruals, where the employer promises to pay the employee a certain amount on retirement.
- Direct insurance where the employer takes out and contributes to a life insurance policy on behalf of the employee. The employee has a direct entitlement to the benefits accrued under the contract against the insurance company.
- "Pensionskassen", which are special insurance companies that serve one or several employers.
- Pension funds which are separate legal entities to the sponsoring entity. Pension funds can be set up by a single company, a financial services provider or by an industry-wide pension scheme sponsored by the employers’ association and the unions.
- Support funds ("Unterstuzungskassen") where the employee has no legal claim against the support fund but directly against the sponsoring employer. Support funds can be sponsored by a single company or can be established as a group support fund that is then used by several companies.

The Federal Agency for Financial Services Supervision (Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin) is the financial supervisor responsible for banking, insurance and securities regulation and supervision.
LAW/POLICY CHANGES SINCE FRESHFIELDS (2005)

Pensions and insurance funds remain subject to the German Insurance Supervision Act (Versicherungsaufsichtsrecht (VAG)), which has undergone only minor changes since 2005.

Mutual funds are now subject to the German Capital Investment Act (Kapitalanlagegesetzbuch – KAGB) which implements the Alternative Investment Fund Manager Directive (AIFMD) and integrates the Undertakings for Collective Investments in Transferable Securities Directives (UCITSD) in Germany. The KAGB replaces the German Investment Act as the central legal regime for mutual funds.

Even though the German legislator has not introduced legally binding principles on responsible investment for pension institutions or insurance funds, the amendments to the VAG in 2005 require pension funds and Pensionskassen to inform the entitled employees (i.e. the beneficiaries) if and how ESG issues are considered in investment decisions, prior to the conclusion of the contract and subsequently on an annual basis. The legislator also made it clear that pension funds and Pensionskassen are expressly permitted to take account of ESG considerations in their investment practices and processes.

PRACTITIONER PERSPECTIVES

Current Practice

Some interviewees commented that Germany is something of a laggard in terms of the proportion of investment organisations that have signed the PRI. They suggested that this reflects the fact that the actions and activities of German asset owners tend to be driven by formal legal requirements and that, in the absence of legal requirements, the default is to carry on with business as usual. They agreed that there is a general reluctance to take on voluntary commitments.

Investor capacity, expertise and knowledge of responsible investment and ESG issues is mixed. Interviewees noted that most have yet to develop formal responsible investment or ESG-related policies or to establish governance processes and systems to implement these policies. Larger or more internationally oriented organisations were considered more likely to explicitly account for ESG issues in their investment processes. This is likely to be driven by commercial (i.e. client demand) and reputational imperatives.

“When we developed our responsible investment approach, we looked at the Freshfields report on fiduciary duty and we also looked at the PRI signatory list. The Freshfields report provided us with the confidence that our approach would not breach our fiduciary duties. The fact that APG, PGGM, Norges Bank etc were all PRI signatories provided us with confidence that responsible investment was an appropriate strategy for asset owners such as BVK.”

Andreas Hallermeier (Sustainability Manager and Assistant to the CIO, Bayerische Versorgungskammer (BVK))

Interviewees commented that relatively few German investors – with the exception of some of the large investment managers – engage with companies. Interviewees pointed to a number of different factors:

- The absence of legal requirements to engage with companies, and the absence of legal provision that would allow BaFin to require investment organisations to engage with companies.
- There is not yet a culture of engagement between German investors and the companies in which they are invested.
- The commonly held view among investors that it is the state’s responsibility to ensure that companies are appropriately governed and manage their environmental and social issues effectively.
Capacity constraints, with only the largest funds having the ability and the resources to engage with companies and/or to effectively delegate and oversee the engagement being conducted by their investment managers.

Limited evidence on the effectiveness of engagement in the German market.

**Legal Framework**

German law contains detailed provisions concerning the duties owed by pension funds and investment funds to their clients and beneficiaries. The central requirement is that these funds need to invest their assets in the best interests of investors. This is defined as financial best interests taking account of the risks associated with the investments. In broad terms, pension funds must ensure that the highest possible security and profitability are guaranteed, that they have sufficient liquidity, that risks are effectively managed and that investments are managed professionally in line with the fund’s investment principles.

Interviewees were clear that legislative requirements do not require ESG issues to be explicitly considered in the investment decision-making for pension funds and insurance reserves. They acknowledged that these funds are permitted to take account of these issues, so long as they continue to comply with the principles of the fund (in particular those relating to security and profitability).

Broadly similar duties and interpretations apply to mutual funds. That is, they need to act in the sole interest of their investors and the integrity of the market when performing their activities, they need to perform their activities with due expertise, care and conscientiousness, and they need to endeavour to avoid and resolve conflicts of interest. In a similar manner to pension and insurance funds, there is no explicit regulatory obligation on mutual funds to implement provisions covering ESG issues in their investment decisions.

Conversely, ESG principles are not excluded from the decision making process per se. Provisions covering ESG issues can be integrated in investment decisions of mutual funds in a legally binding manner if its terms and conditions determining the relationship between the capital investment company and the investor explicitly refer to them, and provided that the scope and application of the mandate is sufficiently detailed.

“BaFin monitors the requirement that retail funds publish the rules that govern how the fund is invested.

Where a fund makes investments that have a particular implication for the risk profile of the fund (e.g. overweight carbon-intensive industries and so with a significant exposure to carbon regulation), BaFin will look closely at how these risks are being managed and the implications for the overall risk profile of the fund.

BaFin does not take a position on whether funds should or should not invest in particular companies or sectors (e.g. renewable energy, nuclear energy, weapons, child labour) but expects funds to be clear on the risks that these investments create and to have a clear strategy for managing these risks.”

Thomas Neumann (Head of Investment Supervision, Federal Financial Supervisory Authority – BaFin)

As noted above, pension funds, pension institutions and private pension insurers do have to provide information, prior to the conclusion of the contract and subsequently on an annual basis, to their beneficiaries and clients on whether and how they address
ethical, social and environmental concerns in the allocation of pension contributions. However, these requirements do not mean that these funds need to have a sustainable investment policy or that they are under obligation to take account of these issues in their investment practices and processes.

There have been a number of self-regulatory or soft law initiatives in Germany. For example, the German Environment Ministry has issued a guidance document on the PRI Principles, and the German Association for Investment and Asset Management (BVI) has published Guidelines for Responsible Investment. However, these documents are not legally binding and they do not have particular standing in legal proceedings.

In addition, mutual funds and pensions funds can declare their compliance with the German Sustainability Code (“Deutscher Nachhaltigkeitskodex”), which explicitly focuses on ESG aspects. By publishing declarations of conformity to the Sustainability Code, the funds can demonstrate to current and potential investors their commitment to specific ESG issues, such as environmental protection, safeguarding workers’ rights and the protection of human rights.

Barriers

Interviewees were clear that the primary barrier to progress in Germany is the absence of formal legal requirements on asset owners and insurance companies to (a) examine long-term investment value drivers (including ESG issues) in their investment processes, (b) engage with the companies or other entities in which they are invested.

Some interviewees also pointed to weaknesses in the evidence base for responsible investment. They pointed, in particular, to the lack of robust evidence on the relationship between ESG issues and investment performance, and the lack of evidence that ESG integration or active ownership add value to investment performance.

A number of interviewees expressed concern about the ESG-related capacity, expertise and resources of German investors, although they acknowledged that this was probably a reflection of the relative lack of demand for responsible investment. They suggested that, if market demand was stronger and the investment case for responsible investment clearer, any capacity gaps would probably be addressed relatively quickly.

Drivers for Change

It is important to recognise that some German investors have made commitments to responsible investment and seventeen asset owners have signed the PRI. This suggests that the current German regulatory framework is, at least, not an obstacle to organisations that want to adopt a responsible investment approach. However, interviewees were clear that, in the absence of explicit legislation requiring ESG integration or formal legal opinion that establishes the principle that ESG integration is required, significantly increasing the number of institutional investors with commitments to responsible investment is likely to take a long time. They were also clear that self-regulatory initiatives (e.g. a German Stewardship code along the lines of those developed in the UK and Japan) are unlikely to make a substantial difference.

Interviewees cautioned against relying too much on changing German legislation, given that changing legislation is likely to be a slow process. They did suggest that European legislation, in particular the Shareholder Rights Directive, offered the potential to accelerate the process of change, given that this legislation needs to be adopted into German law.

“In our view it is difficult to attribute any effect on alpha generation by focusing on ESG issues. Our primary reason for focusing on these issues is to enable us to better manage our risks by reducing volatility and generating better risk-adjusted returns.”

Andreas Hallermeyer (Sustainability Manager and Assistant to the CIO, Bayerische Versorgungskammer (BVK))
RECOMMENDATIONS

In addition to the global recommendations, we recommend that:

**Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)** should require pension funds, pension institutions and insurers to:

- adopt publicly available policies that explain how they address ethical, social and environmental concerns in the allocation of pension contributions;
- publish a public annual report describing how these commitments have affected the actions taken and the outcomes achieved (where the outcomes relate to both investment performance and to the ESG performance of the entities in which they are invested).

**Pension funds** should publicly commit to responsible investment.
COUNTRY ANALYSIS:
UNITED KINGDOM

193 PRI SIGNATORIES
43 ASSET OWNERS

THE UK PENSION MARKET IN NUMBERS
United Kingdom, total investment of pension funds (£bn)

<table>
<thead>
<tr>
<th>Year</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014**</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal GDP (£bn)</td>
<td>1,400</td>
<td>1,800</td>
<td>2,000</td>
<td>2,200</td>
<td>2,400</td>
<td>2,600</td>
<td>2,800</td>
<td>3,000</td>
<td>3,200</td>
<td>3,400 **</td>
</tr>
<tr>
<td>Nominal GDP (€bn)</td>
<td>800</td>
<td>1,200</td>
<td>1,400</td>
<td>1,600</td>
<td>1,800</td>
<td>2,000</td>
<td>2,200</td>
<td>2,400</td>
<td>2,600</td>
<td>2,800 **</td>
</tr>
<tr>
<td>Population (million)</td>
<td>63.7</td>
<td>64.1</td>
<td>64.5</td>
<td>64.9</td>
<td>65.3</td>
<td>65.7</td>
<td>66.1</td>
<td>66.5</td>
<td>66.9</td>
<td>67.3 **</td>
</tr>
<tr>
<td>GDP per capita (£/capita)</td>
<td>25,985</td>
<td>26,731</td>
<td>27,714</td>
<td>28,530</td>
<td>29,350</td>
<td>30,170</td>
<td>31,000</td>
<td>31,830</td>
<td>32,660</td>
<td>33,490 **</td>
</tr>
<tr>
<td>Employment rate (%)</td>
<td>71.0%</td>
<td>71.5%</td>
<td>72.9%</td>
<td>73.3%</td>
<td>73.8%</td>
<td>74.3%</td>
<td>74.8%</td>
<td>75.3%</td>
<td>75.8%</td>
<td>76.3% **</td>
</tr>
<tr>
<td>Population &gt; 65 (%)</td>
<td>17.0%</td>
<td>17.4%</td>
<td>17.7%</td>
<td>17.9%</td>
<td>18.2%</td>
<td>18.5%</td>
<td>18.8%</td>
<td>19.1%</td>
<td>19.4%</td>
<td>19.7% **</td>
</tr>
</tbody>
</table>

* Estimate
** Preliminary data
47 IMF, World Economic Outlook Database, 2015.
50 IMF, World Economic Outlook Database, 2015.
51 OECD: The total labour force, or currently active population, comprises all persons who fulfill the requirements for inclusion among the employed or the unemployed during a specified brief reference period.
53 OECD: Employment rate represent persons in employment as a percentage of the population of working age (15-64 years).
56 OECD, Pension Market in Focus 2014, table 4, 2014 and OECD, Pension Funds in Figures, 2015.
UK, % AUM by type of pension scheme

<table>
<thead>
<tr>
<th>Year</th>
<th>Defined Benefit</th>
<th>Defined Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>74%</td>
<td>26%</td>
</tr>
<tr>
<td>2013</td>
<td>72%</td>
<td>28%</td>
</tr>
<tr>
<td>2014</td>
<td>71%</td>
<td>29%</td>
</tr>
</tbody>
</table>

THE UK INVESTMENT MARKET

The UK is home to the world’s second largest fund management industry and third largest insurance sector. The FTSE 100 has a market capitalisation of £4 trillion.

The UK state pension system comprises the basic State Pension (a flat-rate payment that requires a contribution record of 44 years to receive full benefits), the State Second Pension and the Pension Credit. The government is planning to replace this system with a single state pension.

The state pension system is supplemented by voluntary occupational and voluntary personal pension components. Since October 2012, the government has begun phasing in automatic enrolment, which will result in all employees being placed in a pension scheme unless they actively decide to opt out. A number of new low-cost defined contribution pension vehicles are being launched, aimed at employees who do not have access to a good quality work based pension scheme.

The key regulators are the Financial Reporting Council (FRC), the Financial Conduct Authority (FCA), and the Pensions Regulator. The principal sources for UK law are Parliamentary legislation, common law and the European Union.

LAW/POLICY CHANGES SINCE FRESHFIELDS (2005)

There have been no significant changes to UK law regarding fiduciary duty since 2005, other than the adoption of the Occupational Pensions Schemes (Investment) Regulations 2005 (the Bill that led to these Regulations was discussed in the 2005 Freshfields report).
There have, however, been two important developments; (a) the introduction of the Stewardship Code in 2010, and (b) the inquiries into the fiduciary duties of institutional investors.

The Stewardship Code was introduced in 2010 with the aims of building a critical mass of investors that were willing and able to engage with the companies in which they invested, of increasing the quantity and quality of engagement, and of increasing accountability down the investment chain to clients and beneficiaries. The Code comprises seven, comply-or-explain, elements as follows:

1. Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities.
2. Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship, and this policy should be publicly disclosed.
3. Institutional investors should monitor their investee companies.
4. Institutional investors should establish clear guidelines on when and how they will escalate their stewardship activities.
5. Institutional investors should be willing to act collectively with other investors where appropriate.
6. Institutional investors should have a clear policy on voting and on the disclosure of their voting activity.
7. Institutional investors should report periodically on their stewardship and voting activities.

All UK-authorised investment managers are required under the FCA's Conduct of Business Rules to produce a statement of commitment to the Stewardship Code or to explain why the Code is not appropriate to their business model. By the end of 2014, the Stewardship Code had almost 300 signatories, including over 200 investment managers and over 80 asset owners.

There has been an extensive discussion in the UK about the fiduciary duties of institutional investors. In the wake of the 2008 global financial crisis, Professor John Kay was commissioned by the UK government to conduct a review of the structure and operation of UK equity markets. His report, The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report, published in July 2012, emphasised the need for a culture of long-term decision-making, trust and stewardship to protect savers' interests. The report recognised the essential role that fiduciary duties play in the promotion of such a culture but highlighted the damage being done by misinterpretations and misapplications of fiduciary duty in practice.

In response, the government asked the Law Commission to investigate the subject of fiduciary duty in more detail. In 2014, the Law Commission published its report, Fiduciary Duties of Investment Intermediaries. The report concluded that, among other things, (a) trustees should take into account wider factors relevant to long-term investment purposes, including ESG factors relevant to financial returns, and (b) while the primary focus of pension trustees should be the pursuit of financial returns, trustees were able to take into account wider considerations – including ESG issues relevant to financial returns, macroeconomic factors, non-financial factors (such as quality of life and ‘purely ethical’ concerns) and the views of beneficiaries – provided that such decisions do not cause significant financial detriment. The Law Commission acknowledged that the law on fiduciary duties is “complex, difficult to find and not well known” and that this “may lead trustees to be overly narrow in their approach to investment factors and to their beneficiaries' concerns”.

Following the publication of the Law Commission’s report, the UK government conducted a formal consultation on how the law on investments in occupational pension schemes might be amended. At the time of writing (August 2015), the consultation has closed and the government is reviewing the submissions received.

PRACTITIONER PERSPECTIVES

Fiduciary Duty

The fiduciary duties of pension fund trustees emerge from the common law and from the specific legislation relating to pension funds. The heart of the common law duty is the duty of loyalty, which is generally seen as including the avoidance of conflicts of interest, the duty of confidentiality and the obligation not to profit by virtue of their position at the expense of the principal.
In relation to pensions, trustees and their agents must ensure they act prudently, which is understood as both regulating the level of risk that may be accepted on beneficiaries’ behalf and imposing a ‘duty of care’ that decision makers must apply when making their investment decisions. Essentially those under a fiduciary duty must:

- Exercise the ‘care, skill and diligence’ a prudent person would exercise when dealing with investments for someone else for whom they feel ‘morally bound to provide’.
- Apply the special knowledge and experience they possess or, if they are professional trustees, the skills expected of a professional trustee.
- Have regard to the need for diversification of investments and have regard to the suitability of each investment.
- Obtain and consider proper advice on certain matters, such as whether an investment complies with the Statement of Investment Principles required for occupational pensions.
- Take account of all relevant considerations and ignore irrelevant considerations. Interviewees suggested that this would require attention to be paid to those factors that could materially influence the performance of the investment or investments in question over the relevant time horizon.
- Act reasonably by being able to show that they have weighed up the considerations that they have identified as relevant and arrived at a decision that could not be said to be irrational, perverse or absurd.

Mercer encourages all clients to take a long-term perspective (where long-term may refer to the life of the fund for pension funds or in perpetuity for certain foundations).”

Lucy Tusa (Principal, Mercer)

The duty to act prudently has been modified for occupational pension funds (under the 2005 Occupational Pension Schemes (Investment) Regulations) so that trustees must ‘ensure the security, quality, liquidity and profitability of the portfolio as a whole’ and ensure that assets are properly diversified.

The Law Commission’s 2014 Report stated that the primary concern of trustees must be to generate appropriate risk-adjusted returns. In doing so, trustees should take into account factors that are financially material to the performance of an investment, which may include ESG factors. Interviewees commented that there appears to be an emerging consensus among legal practitioners and investment professionals that the integration of ESG factors into investment decision-making will become the norm even if not prescribed by the law.

“UK local authorities have obtained a QC opinion which concluded that it is not appropriate for local authorities to divest on ethical grounds if it causes financial detriment. However, based on the advice received, we have concluded that the main elements of our approach to responsible investment – voting our holdings, engaging with companies, investment managers and policymakers on financially material ESG issues – are entirely compatible with our fiduciary duties.”

Mark Chaloner (Assistant Director – Investments, West Midlands Pension Fund)
Despite this, fiduciary duty continues to be advanced as a reason why asset owners cannot integrate ESG issues into their investment processes or cannot engage with companies. Interviewees commented that this partly reflects the absence of a permissive or positivist definition of fiduciary duty in legislation (i.e. one that requires asset owners to take action on ESG issues). It also reflects the reality that asset owners face a whole series of practical challenges, including resource constraints, pension deficits, and extensive compliance requirements. These challenges mean that, in the absence of strong regulatory or other drivers, asset owners are often reluctant to focus attention or resources on responsible investment.

In relation to the Stewardship Code, interviewees commented that being a signatory to the Code is now a standard expectation of asset owners and investment consultants in the UK market. While the Code has sent a clear signal that asset owners and investment managers are expected to engage with the companies in which they are invested, relatively little attention has been paid to the manner in which the Code is being implemented by signatories.

“The argument that ESG integration is part of good governance for pension funds has been broadly supported across the political spectrum. In fact, ministers of all parties have seen ESG integration as non-problematic.”

Paul Watchman (Honorary Professor, School of Law, University of Glasgow)

Interviewees also pointed to two specific content issues with the Stewardship Code. The first relates to the lack of explicit attention paid to environmental and social issues in the Code. This lack of emphasis suggests that these issues are of significantly less importance than corporate governance as drivers of long-term investment value. The second is that the Code is seen as primarily relevant to organisations that engage directly with companies, and less relevant to organisations that outsource investment management (and associated activities) to their investment managers. The Code does not explain how these organisations (i.e. those that delegate authority) are expected to deliver on their stewardship obligations.

**Current Practice**

UK asset owners, in particular the larger funds, increasingly see ESG integration and stewardship as standard parts of their investment processes. For example, in its 2014 review of the Stewardship Code, the FRC noted that the proportion of asset owners where ‘all’ or ‘some’ mandates refer to stewardship had increased to 83% (from 71% in 2012 and from 65% in 2011). Interviewees pointed to a similar trend in relation to the PRI, with some commenting that being a PRI signatory is now seen as a core expectation of investment managers looking to attract UK institutional clients.

Despite these positive signs, a number of interviewees commented that it is not clear how asset owners’ responsible investment-related activities are monitored or whether their performance on responsible investment affects appointment and reappointment decisions. This is compounded by the focus of most asset owners on short-term investment performance.

In this context, it is important to highlight the publication in early 2015 of *A Guide to Responsible Investment Reporting in Public Equity*. The guide was supported by sixteen UK pension funds, including BT Pensions Scheme, Environment Agency Pension Fund, Merseyside Pension Fund, National Employment Savings Trust (NEST), Pension Protection Fund, Railpen, USS and West Midlands Pension Fund. The participating organisations intend using the guide to inform their engagement with, and monitoring of, both current and prospective fund managers’ approaches to ESG integration and stewardship.
“The active ownership and responsible investment demands on asset managers (even passive managers) are only going to grow. At the same time, there is downward pressure on fees from all quarters, making this a very tough environment for investment managers.”

Lucy Tusa (Principal, Mercer)

Interviewees also highlighted the variation in asset owners’ capabilities on ESG issues. Some are seen as very sophisticated, with their approach to ESG integration and responsible investment being clearly linked to their organisational objectives. For others, the approach is much less strategic and much more driven by factors such as ‘needing to comply with PRI’.

“The Law Commission review has made it clear that investors should do more engagement and should pay more attention to long-term investment returns/performance. The reality is that asset managers – because of their resources, capabilities – need to lead these efforts. But it does require asset owners to press them to do so.”

David Styles (Head of Corporate Governance and Stewardship, Financial Reporting Council)

Finally, transparency remains an issue. Many asset owners provide little insight into, for example, how company engagement links to their investment decision-making or how ESG integration influences their investment performance. The FRC reached similar conclusions in its 2014 review of the Stewardship Code, finding that not all signatories were reporting against all seven principles of the Code, that there was significant variation in the quality of information provided by those that did report, and that many organisations had not even updated their information to reflect changes made to the Code in 2012.

Barriers to Progress

Interviewees pointed to a number of distinct barriers to progress:

- The lack of clear legal guidance that asset owners should pay attention to long-term factors and considerations, including ESG issues, in their decision-making and in the decision-making of their agents.
- The lack of detailed oversight of the Stewardship Code at the aggregate level (i.e. how is investor engagement affecting corporate practice?) and at the level of the individual investor (i.e. how do investors compare to each other?).
- The perception – often reinforced by consultant and legal advice – that fiduciary duty permits only the maximisation of financial returns.
- The lack of explicit attention on environmental and social issues in the Stewardship Code.
- The tendency of investors to focus on corporate governance issues (in particular remuneration), to the relative exclusion of social and environmental issues (perhaps with the exception of climate change). This reflects perceptions on the relative importance of these issues to long-term investment performance, as well as the practical challenges associated with assessing how environmental and social issues affect long-term valuations.
- Capacity needs in the investment industry. For example, asset owners need to develop their ability to scrutinise and hold investment managers to account for their approach to ESG integration.
"Fiduciary duty is a trust law concept, whereas an increasing proportion of sol the pensions industry is now contract-based, with the majority of institutional assets being managed by organisations that do not see themselves as being bound by fiduciary duties. Contract-based approaches, notwithstanding the rhetoric, have much lower standards of fiduciary duty and the FCA rules do not replicate the fiduciary standards that apply to trust-based pension funds.”

Bethan Livesey (Policy Officer, ShareAction)

"The Law Commission stated that taking account of ESG issues is permissible and that members’ views can be taken into account. The UK government has used this to argue that legislation is not required (although it could send a stronger signal by replicating the relevant company law requirements in pensions law).”

Paul Watchman (Honorary Professor, School of Law, University of Glasgow)

Drivers for Change
Interviewees agreed that it is likely that more UK institutional investors will conclude that responsible investment is aligned with their fiduciary duties. They expect this to be driven by a combination of peer pressure, market demand, reputational pressure (e.g. not wanting to be on the front page of the FT) and regulatory pressure (e.g. the FRC paying more attention to the implementation of the Stewardship Code). They also agreed that progress could be accelerated if the UK government were to clarify that asset owners’ fiduciary duty requires them to pay attention to long-term factors (including ESG issues) in their decision-making, and in the decision-making of their agents.

RECOMMENDATIONS
In addition to the global recommendations, we recommend that:

The government should amend the Occupational Pensions Schemes (Investment) Regulations to:
- clarify that fiduciary duty requires them to pay attention to long-term factors (including ESG factors) in their decision-making, and in the decision-making of their agents;
- clarify that responsible investment includes ESG integration, engagement, voting and public policy engagement;
- require asset owners to report on how they implement their policies and statements of investment principles. The Pensions Regulator should ensure that asset owners provide meaningful disclosure, by providing guidance on reporting and by critically scrutinising their disclosure.
The Financial Reporting Council (FRC) should:

- conduct a more detailed analysis of current implementation of the UK Stewardship Code by analysing asset owners’ oversight of their investment managers’ implementation and by analysing the investment and other outcomes that result from the code;
- highlight those asset owners and investment managers that it considers to be doing a good job of implementing the stewardship code, and those whose implementation appears to be lagging;
- strengthen the stewardship code by:
  - making it clear that environmental and social issues are important drivers of long-term investment value;
  - providing clear guidance to asset owners that outsource investment management (and associated activities) on how they are expected to deliver on their stewardship obligations.

Corporate pension funds should sign the stewardship code and make public commitments to responsible investment.
COUNTRY ANALYSIS:
JAPAN

THE JAPANESE PENSION MARKET IN NUMBERS

Japan, total investment of pension funds (¥bn)

<table>
<thead>
<tr>
<th>Year</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014**</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>5,954</td>
<td>4,919</td>
<td>4,616</td>
<td>4,210</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td>475,110</td>
<td>480,128</td>
<td>487,882</td>
<td>500,736</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td>127.6</td>
<td>127.3</td>
<td>127.0</td>
<td>126.7</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2016</td>
<td>65.2</td>
<td>65.5</td>
<td>65.8</td>
<td>65.4</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2017</td>
<td>70.6%</td>
<td>71.7%</td>
<td>72.7%</td>
<td>72.5%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2018</td>
<td>24%</td>
<td>25%</td>
<td>26.1%</td>
<td>26.4%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Estimate
** Preliminary Data
58 IMF, World Economic Outlook Database, 2015.
60 IMF, World Economic Outlook Database, 2015.
61 IMF, World Economic Outlook Database, 2015.
62 OECD: The total labour force, or currently active population, comprises all persons who fulfill the requirements for inclusion among the employed or the unemployed during a specified brief reference period.
64 OECD: Employment rate represent persons in employment as a percentage of the population of working age (15-64 years).
67 OECD, Pension Market in Focus 2014, table 4 available here and OECD, Pension Funds in Figures, 2015.
THE JAPANESE INVESTMENT MARKET

Tokyo is the fifth largest investment management market, the fifth largest banking market and the eighth largest insurance market in the world. The Japan Exchange Group is the third largest stock exchange globally with a market capitalisation of over US$4 trillion as of October 2014.

Japan’s pension system comprises a two-tiered public system and a private system. The two public pensions are the National Pension (a basic pension, paid for through employee taxes and general taxation) and the Welfare Pension Insurance, funded by contributions from employers and employees. The assets of these two public schemes are managed by the Government Pension Investment Fund (GPIF). GPIF, with approximately ¥140trillion in assets under management, is the world’s largest pension fund.

Private corporations often offer additional pension benefits on the top of those offered by the public pensions. These funds are usually funded by contributions from the employer companies, although employees also occasionally make contributions.

The key regulators are the Financial Services Agency (FSA) and the Ministry of Health, Labour and Welfare (MHLW). The FSA is responsible for policymaking for the financial system and for the inspection and supervision of private sector financial institutions and other market participants, including exchanges. The MHLW is responsible for the maintenance and promotion of the health, labour and welfare of the Japanese nation including the public and corporate pension systems.

LAW/POLICY CHANGES SINCE FRESHFIELDS (2005)

There have been no changes in legislation relating to responsible investment since the Freshfields report was issued in 2005.
Japan has, however, adopted two voluntary codes that are of direct relevance to responsible investment and ESG integration. These are the Stewardship Code (introduced in 2014) and the Corporate Governance Code (introduced in 2015, which sets out fundamental principles for effective corporate governance at listed companies in Japan, including a requirement that companies should take appropriate measures to address sustainability issues). The codes were introduced as part of a wider programme of policies (commonly referred to as ‘Abenomics’) directed at stimulating economic growth.

The Stewardship Code states that institutional investors should aim to ‘enhance the medium-to long-term return on investments for their clients and beneficiaries by improving and fostering investee companies’ corporate value and sustainable growth through constructive engagement, or purposeful dialogue’. The Code requires institutional investors to have clear policies on how they fulfil their stewardship responsibilities, on how they manage conflicts of interest and on how they vote their shareholdings. It requires them to monitor, to support the sustainable growth of, and to actively engage with, investee companies. The factors to be considered in these processes ‘may include, for example, governance, strategy, performance, capital structure and risk management (including how the companies address risks arising from social and environmental matters)’. Finally, institutional investors are expected to report on how they have implemented the Code.

The Stewardship Code is a comply-or-explain code. It is up to each institutional investor to decide for itself whether it will support and adopt the Stewardship Code. Furthermore, the individual elements of the Code can be adopted on a comply-or-explain basis, allowing signatories to adopt all of the Code or explain why they choose not to adopt any particular principle. As of 31 May 2015, 191 institutional investors, including the GPIF, had adopted the Stewardship Code.

The FSA is responsible for monitoring the Stewardship Code, and for encouraging investment organisations to sign the Code. Every three months, the FSA produces a list of signatories to the Code. The FSA also provides links to signatories’ websites where additional information on their approach to the Stewardship Code can be found.

**PRACTITIONER PERSPECTIVES**

**Current Practice**

Interviewees agreed that there is growing interest in responsible investment and stewardship (engagement) in Japan. They noted that asset owners – in particular public pension funds – are starting to pay much more attention to ESG issues in their investment practices, and are starting to ask questions of their investment managers.

“ESG analysis is very new for most Japanese investment managers. As a consequence, Secom does not want to put too much pressure on investment managers but instead wants to work with them to help them develop their capacity and expertise.”

Hiroichi Yagi (Managing Director, Secom Pension Fund)

However, the market for responsible investment is immature, with many asset owners and investment managers at the early stages in their implementation of responsible investment. There is limited evidence that responsible investment considerations are being incorporated into, for example, investment management mandates.

Most of the major investment managers in Japan are now signatories to the Stewardship Code along with a number of major public funds (including GPIF). These organisations have started to establish stewardship policies and voting guidelines. Practitioners commented that, even though the Code has only been in place since 2014, there are signs that it is having an influence on investment practice. For example, investors are asking an increasing number of questions about ESG issues in their meetings with companies.
“It is too early to say whether the Stewardship Code has changed Japanese investors’ approach to engagement. The Code represents a significant change in expectations of Japanese investors and we will need five or six years of focused monitoring and implementation before we can tell whether it has delivered real change in investor practice.”

Tetsuo Kitagawa (Professor of Finance and Corporate Governance, Graduate School of International Management, Aoyama Gakuin University, Japan)

Relatively few corporate pension funds have yet to sign the Stewardship Code. Interviewees pointed to three possible reasons. The first is that corporate pension funds have tended to lag their public sector counterparts on responsible investment-related issues. The second is that they may be waiting until they are confident that their sponsor companies comply with the requirements of the Corporate Governance Code. The third is that the pension funds’ parent companies may be reluctant for their pension funds to engage with companies, because it might affect their business relationships with these companies.

Legal Context

The Civil Code of Japan sets out the general duties of persons that manage the affairs of others. Article 644 of the Civil Code requires a person who is under a duty to manage another person’s affairs under an agreement, to perform his or her duties with the care required of a ‘good and conscientious manager’. It is widely accepted by legal practitioners and the courts that the ‘duty of loyalty’ is a part of the duties required under Article 644. The duty of loyalty is generally taken as requiring managers (or trustees) to perform their duties in good faith on behalf of the company (or beneficiaries in the case of pension funds) and to avoid conflicts of interest. Interviewees commented that these duties are similar to those required under the ‘prudent person’ rules in other jurisdictions.

“Although the term ‘fiduciary duty’ is commonly translated by law scholars in Japan as ‘Jyutakusha-Sekinin’ and is a widely recognised concept among regulators, investors and companies, the term fiduciary duty is not explicitly stated in Japanese laws and regulations. Japanese law refers to duties of care and of loyalty, and these terms broadly correspond to the term fiduciary duty as defined in other countries. Because the term fiduciary duty is not defined by Japanese laws, the Stewardship Code uses the term ‘Stewardship Responsibility’ to capture the idea that investors should look to enhance the mid- to long-term corporate value and the sustainable growth of investee companies.”

Amane Fujimoto (Corporate Accounting & Disclosure Division, Planning and Coordination Bureau, Financial Services Agency)
The requirements of Article 644 also apply to the trustees of pension funds. These trustees may also be subject to specific duties under pensions or investment law. For example, the GPIF Act stipulates that the directors of the GPIF must exercise the duty of care of a prudent manager and that they must perform their duties faithfully on behalf of the fund. For corporate pension funds, the administrators of these funds owe a duty of care and a duty of loyalty under the Civil Code to the employer who established the pension fund. Although the duties owed to beneficiaries are not specified, it is generally understood that general duties of care and loyalty are also owed to the beneficiaries of the pension fund, and that the administrators of these funds must seek to maximise financial returns for beneficiaries.

Drivers for Change

Asset owners – specifically public pension funds – have started to pay much more attention to ESG issues since 2014. Interviewees pointed to a number of factors that have influenced this growth in interest:

- The increased exposure of asset owners to listed equities as a result of Abenomics encouraging Japanese pension funds to move from Japanese government debt to equities. This has meant that asset owners have had to develop their understanding of ESG issues as part of developing a long-term picture of the companies in which they are invested.
- The introduction of the Stewardship Code and the fact that the Code has been signed by 191 institutional investors is likely to induce other pension funds to sign the Code.
- International practices and approaches to responsible investment. Interviewees pointed to different factors as having an influence on the Japanese market: (a) the growth and profile of the PRI in Japan (both in terms of raising the awareness of responsible investment and in terms of building capacity), (b) the Abenomics objective of increasing foreign investment in the Japanese equities market through strengthening shareholder rights and Japanese corporate governance, (c) the desire to align the Stewardship Code with international best practices, with the UK Stewardship Code being of particular interest, and (d) the fact that a number of international investment managers signed and strongly supported the Stewardship Code.

Barriers and Challenges

Interviewees identified a number of distinct barriers to progress:

- Many Japanese investors continue to have concerns about whether ESG analysis is the same as screening.
- Japanese investors are concerned that implementing responsible investment may be a breach of their fiduciary duties.
- There is a lack of robust evidence on the relationship between environmental and social issues and investment performance. Interviewees commented that this contrasts with corporate governance where the relationship between corporate governance and investment returns has been clearly established.
- The relatively limited expertise in Japan in areas such as ESG integration and active ownership.
- The relatively limited attention being paid by corporate pension funds to ESG integration and responsible investment.
- The weaknesses in the disclosures being provided by companies on their social, environmental and governance performance. This limits investors’ ability to integrate consideration of these issues into their investment practices and processes. Interviewees commented that the Corporate Governance Code will encourage better corporate disclosures on environmental and social as well as governance issues. This should make it easier to investors to take account of these issues in their investment processes.

While it is too early to make a definitive assessment, some interviewees questioned whether the progress that has been seen to date on stewardship (active ownership) will be maintained. They commented that the comply-or-explain approach that underpins the Code is new for Japan and it remains to be seen whether Japanese investors will work within the spirit of comply-or-explain or whether they will end up defaulting to boilerplate activities and reporting. They acknowledged that the FSA has encouraged industry organisations to work with these principles, rather than simply creating standard templates and checklists, but suggested that the FSA needs to look closely at the quality of engagement being conducted and the outcomes being achieved.
“Improving the sustainability performance and reporting of Japanese companies is key to encouraging greater domestic investment in listed equities and attracting international investors to the market. Interest – among listed companies and among pension funds – in ESG integration and responsible investment will grow if companies include information on their pension funds as an integral part of their wider corporate reporting, and if companies ensure that there is alignment between their corporate responsibility commitments and the responsible investment commitments of their pension funds.”

Hiroichi Yagi (Managing Director, Secom Pension Fund)

**RECOMMENDATIONS**

In addition to the global recommendations, we recommend that:

- The Financial Services Agency (FSA) should continue to monitor the implementation of the Japanese Stewardship Code, analysing asset owner oversight of their investment managers’ implementation and analysing the investment and other outcomes that result from the code.

- The Ministry of Health, Labour and Welfare (MHLW) should require public and corporate pension funds to state how they integrate ESG issues into their investment decisions. As part of these requirements, MHLW should commit to:
  - review progress annually;
  - explain how asset owners integrate ESG issues into their investment processes;
  - analyse how these commitments have affected the actions taken and the outcomes achieved (where the outcomes relate to both investment performance and to the ESG performance of the entities in which they are invested).

- Corporate pension funds should sign the stewardship code and publicly commit to responsible investment.

- Investment banks should produce more research on the drivers of long-term investment value (including ESG factors).
COUNTRY ANALYSIS:
SOUTH AFRICA

THE SOUTH AFRICAN PENSION MARKET IN NUMBERS
South Africa, total investment of pension funds (Rbn)

<table>
<thead>
<tr>
<th>Year</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015*</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP (Sbn)</td>
<td>397.4</td>
<td>366.2</td>
<td>350.1</td>
<td>323.8</td>
</tr>
<tr>
<td>GDP (Rbn)</td>
<td>3,262</td>
<td>3,534</td>
<td>3,796</td>
<td>4,081</td>
</tr>
<tr>
<td>Population (million)</td>
<td>52.3</td>
<td>53.1</td>
<td>54.0</td>
<td>54.8</td>
</tr>
<tr>
<td>GDP per capita (R/capita)</td>
<td>62,331</td>
<td>66,488</td>
<td>70,302</td>
<td>74,402</td>
</tr>
<tr>
<td>Labour Force (million)</td>
<td>22.31</td>
<td>22.79</td>
<td>23.21</td>
<td>24.19</td>
</tr>
<tr>
<td>Employment Rate</td>
<td>36%</td>
<td>36.1%</td>
<td>35.1%</td>
<td>36.1%</td>
</tr>
<tr>
<td>Population &gt; 65%</td>
<td>5.3%</td>
<td>5.3%</td>
<td>5.5%</td>
<td>5.7%</td>
</tr>
</tbody>
</table>

* Estimate

69 IMF, World Economic Outlook Database, 2015.
70 IMF, World Economic Outlook Database, 2015.
71 IMF, World Economic Outlook Database, 2015.
72 IMF, World Economic Outlook Database, 2015.
73 OECD: The total labour force, or currently active population, comprises all persons who fulfill the requirements for inclusion among the employed or the unemployed during a specified brief reference period.
75 OECD: Employment rate represent persons in employment as a percentage of the population of working age (15-64 years).
77 Statistics South Africa, P0302 - Mid-year population estimates, 2015.
THE SOUTH AFRICAN INVESTMENT MARKET

The JSE All Share Index has a market capitalisation of approximately R10 trillion (or approximately US$1 trillion).

The South African pension system comprises a non-contributory, means-tested state old age pension, supplemented by various employer-supported and employment contract-based pension and provident fund arrangements and voluntary retirement savings funds. While employers are not required to contribute to retirement funds for the benefit of their employees, employer-based retirement plans have a long history in South Africa, largely due to significant tax incentives.

The statutory private retirement funding framework has been in place since 1958 when the Pension Funds Act became effective, although occupational pensions funds had existed in South Africa for many years before that. Most private sector pension schemes are defined contribution schemes, whereas those in the public sector tend to be defined benefit schemes. Defined contribution pension arrangements are typically in the form of a provident fund or a pension fund; both are similar, but differ with regard to tax-exempt contribution limits and the tax treatment of retirement benefit options.

The Financial Services Board (FSB) is responsible for the licensing, supervision and enforcement of legislation relating to almost all South African pension funds and their service providers. The largest pension fund, the Government Employees Pension Fund, and a few other funds established under laws other than the Pension Funds Act, are not subject to oversight by the FSB. Pension fund policy is implemented by Parliament through national legislation, by the National Treasury issuing regulations and by the FSB’s registrar of pension funds issuing other forms of subordinate legislation.
LAW/POLICY CHANGES SINCE FRESHFIELDS (2005)
South Africa was not covered by the original Freshfields report in 2005.

There have been two significant changes since 2005, namely the 2011 changes to Regulation 28 to the Pension Funds Act, and the introduction in 2012 of the voluntary Code for Responsible Investing in South Africa (CRISA).

The overhaul of Regulation 28 was spurred by the global financial crisis, by the need to modernise regulations to reflect current investment practice, by the need to reduce systemic risk, and by the need to improve the protection for pensioners. The changes included a prohibition on the exclusive reliance on credit rating agencies when making investment decisions and a general emphasis on the importance of comprehensive due diligence. In the specific context of ESG integration, the most notable change was the requirement for retirement funds to consider ESG factors when making investment decisions. Specifically, Regulation 28(2)(c)(ix) states: ‘Before making an investment in and while invested in an asset [the fund and its board must] consider any factor which may materially affect the sustainable long-term performance of the asset including, but not limited to, those of an environmental, social and governance character’. The preamble to Regulation 28 explains that: ‘Prudent investing should give appropriate consideration to any factor which may materially affect the sustainable long-term performance of a fund’s assets, including factors of an environmental, social and governance character. This concept applies across all assets and categories of assets and should promote the interests of a fund in a stable and transparent environment’.

CRISA, which is a voluntary industry code overseen by the CRISA Committee, came into effect in 2012. CRISA has five main elements, namely that institutional investors should:
- Incorporate sustainability considerations, including ESG issues, into their investment process as part of the delivery of superior risk-adjusted returns to the ultimate beneficiaries.
- Demonstrate acceptance of ownership responsibilities in their investment arrangements and investment activities.
- Consider, where appropriate, a collaborative approach to promote acceptance and implementation of the principles of CRISA and other codes and standards applicable to institutional investors.
- Recognise the circumstances and relationships that hold the potential for conflicts of interest and proactively manage these when they occur.
- Be transparent about the content of their policies, how the policies are implemented and how CRISA is applied to enable stakeholders to make informed assessments.

Signatories are expected to report at least annually, on an apply-or-explain basis, on how they have implemented CRISA.

PRACTITIONER PERSPECTIVES
Current Practice
A recurring theme from the interviews was that there is a general lack of transparency in the South African pensions industry. Beyond the large government funds, it is difficult to tell from the outside what assets have been invested in, let alone whether or how ESG issues have been taken into account in investment decisions or how asset owners have discharged their ownership (or stewardship) responsibilities.

“The logic underpinning CRISA is that investors should take account of the impacts of how the company makes its money on the environment, society and the economy. Not to do so would amount to a failure of the director’s duty of care in the changed world of the 21st century.”

Professor Mervyn King
Interviewees commented that there appears to be increased asset owner awareness of and activity on ESG issues and responsible investment more generally. These are increasingly important parts of due diligence processes, although it is not clear how important they are in investment manager appointment and reappointment decisions.

“Pension funds are required to have investment policy statements that describe their investment policies and objectives as determined by their liability profiles and risk appetites, and which address prescribed matters including the requirement that they consider any factors, including environmental, social and governance factors, that may materially affect the long-term performance of assets before making decisions to invest in them and while invested in them. However, most funds have vague policy statements which provide little, if any, information on specific policy decisions by the funds with which the regulator can enforce compliance.”

Rosemary Hunter (Deputy Executive Officer: Retirement Funds, Financial Services Board, South Africa)

CRISA and, arguably, Regulation 28 expect pension funds to explain how they account for ESG issues in their practices and processes. A number of interviewees commented that investment managers are being asked to help their larger asset owner clients to comply with these requirements through providing data and evidence on implementation and on the effectiveness (or influence) of the actions being taken.

Interviewees also noted that there is a clear difference between large funds (which tend to be interested in ESG issues) and smaller funds. The smaller funds tend to be resource constrained, lack expertise and rely heavily on advice from investment consultants and product providers. Training was identified as one part of the solution to this problem but interviewees also stressed the importance of professionalising pension fund boards, of ensuring that boards are competent to discharge their responsibilities and of strengthening pension fund governance.

Fiduciary Duty

Retirement funds’ duties are based on both the common law as well as statute, in particular the Pensions Funds Act. The common law duties that apply to retirement funds and to other institutional investors are generally seen as including acting in good faith and with loyalty in the best interests of the rights-holder, avoiding conflicts of interests and discharging duties with the necessary prudence, due care and diligence.

Sections 7C and 7D of the Pension Funds Act codify some of the duties of boards of retirement funds. These include existing common law duties such as acting in good faith, acting with due care and diligence, and avoiding conflicts of interest. An amendment to the Pension Funds Act (effective 2014) states that the board of a retirement fund has ‘a fiduciary duty to members and beneficiaries in respect of accrued benefits or any amount accrued to provide a benefit, as well as a fiduciary duty to the fund, to ensure that the fund is financially sound and is responsibly managed and governed in accordance with the rules and this Act’.

While the full implications of this amendment have not been considered by the courts, in a recent judgment of the Supreme Court of Appeal in City of Johannesburg & others v the South
The ‘best practice’ funds’ ESG practices can largely be attributed to the skills and competencies of their trustees who are key drivers of fund demand for ESG implementation. Often these funds have trustees who understand the importance of ESG and champion ESG strategy from within the fund.

However, in most funds that I am aware of, trustees do not apply their minds to ESG. If they do engage with ESG, they tend to outsource it to service providers. In our view, fiduciary law dictates that trustees should not simply delegate in this way, but should instead have robust processes for setting expectations and fund policy, monitoring implementation and assessing outcomes, in collaboration with their service providers.”

Hannine Drake (Senior Associate, Bowman Gilfillan)

African Local Authorities Pension Fund & others [2015] ZASCA 4 (9 March 2015), the court said [Emphases added]: ‘[13]… I do not agree with the notion that s 7C(2) entitles a pension fund or its board to litigate on behalf of its members. Section 7C deals with the object of the board, which is to direct and control the operations of the fund. Subsection (2) then proceeds to give guidance to the board as to how that object should be pursued. In so far as the section enjoins the trustees to act in the interests of members, it must therefore be understood in the context of steps taken in the direction, control and oversight of the fund. It does not appoint the board as the agent or representative of members to conduct litigation on their behalf, even against the wishes of individual members. As illustrated by the facts of this case, the interests of all the members of a fund do not always coincide. Furthermore, there is the obvious potential of a conflict between the interests of the fund, on the one hand, and those of its members, on the other. Section 7C(2) cannot possibly be understood to preclude the individual members in the event of such conflict to contest the actions of the board, which would be the consequence of the interpretation attributed to the section by the court a quo.’

While the case concerned the question of whether a fund can be regarded as representative of its members in the context of litigation, it is probably implicit in this judgment that the fiduciary duties owed by trustees of a fund to the fund itself – fulfilled by ensuring that it fulfils its principal object (to provide value for money benefits to its members, current and future) – ranks ahead of the fiduciary duties owed by them to individual current members.

“We see CRISA as being entirely consistent with legal requirements on fiduciary duty.”

Rosemary Hunter (Deputy Executive Officer: Retirement Funds, Financial Services Board, South Africa)

Regulation 28 is seen as a key development in relation to ESG integration and responsible investment. Interviewees commented that the regulation puts ESG issues to front of mind as a factor to be considered in investment decision-making, and removes any uncertainty around whether retirement funds have such obligations. However, Regulation 28 is seen by practitioners as, at least to some degree, being conceptually separate to the fiduciary
duty requirements of the Pension Funds Act. That is, it is not clear whether this separately legislated ESG obligation was intended to be a development or clarification of fiduciary law, or whether the obligation was intended to be a separate additional duty imposed by law on retirement funds and their boards.

Drivers of Change
While there was a general agreement that there has been significant progress in relation to policy – one interviewee commented that ‘all of the tools and policy measures necessary to implement responsible investment are in place or available’ – there was also a general sense that enforcement is lagging. Interviewees noted that South African pension funds are very responsive to the law, and that, ultimately, the law is likely to be the most effective vehicle for change. They acknowledged that the introduction of new legislation would take time but suggested, at least as an initial step, that interpretative guidance on issues such as reporting and board competence from the FSB would have a similar effect (albeit acknowledging that such circulars do not have the same standing as statutory instruments).

Barriers to Progress
Interviewees pointed to a number of distinct barriers to progress:

- The lack of regulatory guidance: While Regulation 28 provides a very helpful in-principle obligation to implement ESG considerations into investment decision-making processes, further guidance is required on how this might be implemented in practice.
- The lack of reporting requirements: There are no requirements on retirement funds to report regularly to the FSB on how they have implemented the requirements of Regulation 28.
- The lack of effective oversight of the implementation of CRISA or of the ESG requirements of Regulation 28: The lack of oversight and the lack of consequences for non-compliance has resulted in ESG integration and responsible investment remaining a low priority for most retirement funds.

It is important that investors use their power as providers of capital to ensure that companies report in a clear, concise and understandable manner about how their business model impacts financially, socially and environmentally. Investors, be they asset owners or asset managers, have a duty to their ultimate beneficiaries, to report in a clear, concise and understandable manner. They are accountable and to be accountable one has to be understandable, so that the reader can make an informed assessment about long term value creation.”

Professor Mervyn King

- The lack of transparency in the investment industry: Funds are generally not required to publish, even if only to their own members, information on how they address ESG issues in their investment practices and processes.
- Lack of board capacity and expertise: The Pension Funds Act was amended in 2014 to provide that board members of funds must attain and maintain a certain skill level which is to be prescribed by the FSB. At the time of writing (August 2015), it is not clear what emphasis will be placed on ESG issues in the criteria or guidance to be issued by the FSB.
• Limited regulatory resources and competing regulatory agendas: The regulators of the South African pensions industry are faced with a series of major challenges (e.g. the need to consolidate the industry, the need to protect beneficiaries’ interests), of which ESG integration and responsible investment is just one.

• A lack of robust evidence on the investment value of ESG issues.

RECOMMENDATIONS

In addition to the global recommendations, we recommend that:

The Financial Services Board should:

• clarify that compliance with the requirements of Regulation 28, in particular those relating to ESG issues, should be seen as an integral part of the fiduciary duties imposed by the Pension Funds Act;

• clarify that responsible investment includes ESG integration, engagement, voting and public policy engagement;

• explicitly address ESG-related competence, expertise and skills in forthcoming guidance on pension fund board education;

• require asset owners to prepare a public, annual report describing how they have integrated responsible investment into their investment policy statements, practices and processes, and their investment manager selection, appointment and monitoring processes.

The Code for Responsible Investing in South Africa (CRISA) Committee should strengthen oversight of the code by conducting more detailed analysis of current practice, analysing the investment and other outcomes that result from the code.
# COUNTRY ANALYSIS: UNITED STATES

## THE US PENSION MARKET IN NUMBERS

United States, total investment of pension funds ($bn)

<table>
<thead>
<tr>
<th>Year</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014**</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value ($bn)</td>
<td>8,000</td>
<td>10,000</td>
<td>11,000</td>
<td>12,000</td>
<td>13,000</td>
<td>14,000</td>
<td>15,000</td>
<td>16,000</td>
<td>17,000</td>
<td>18,000</td>
</tr>
</tbody>
</table>

## Key Statistics

**Nominal GDP ($bn)**

<table>
<thead>
<tr>
<th>Year</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015*</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP ($bn)</td>
<td>16,163</td>
<td>16,768</td>
<td>17,418</td>
<td>18,124</td>
</tr>
<tr>
<td>Population (million)</td>
<td>314.4</td>
<td>316.7</td>
<td>319.0</td>
<td>321.2</td>
</tr>
<tr>
<td>GDP per capita ($/capita)</td>
<td>51,409</td>
<td>52,939</td>
<td>54,596</td>
<td>56,421</td>
</tr>
<tr>
<td>Labour force (million)**</td>
<td>154.9</td>
<td>155.6</td>
<td>156</td>
<td>157.1</td>
</tr>
<tr>
<td>Employment rate</td>
<td>67.1%</td>
<td>67.3%</td>
<td>68.1%</td>
<td>--</td>
</tr>
<tr>
<td>% Population &gt; 65*</td>
<td>13.7%</td>
<td>14.1%</td>
<td>14.5%</td>
<td>--</td>
</tr>
</tbody>
</table>

---

* Estimate  
** Preliminary  
80 MF, World Economic Outlook Database, 2015.  
81 IMF, World Economic Outlook Database, 2015.  
82 IMF, World Economic Outlook Database, 2015.  
83 OECD: The total labour force, or currently active population, comprises all persons who fulfil the requirements for inclusion among the employed or the unemployed during a specified brief reference period.  
85 OECD: Employment rate represent persons in employment as a percentage of the population of working age (15-64 years).  
86 OECD, Employment rate, 2015.  
88 OECD, Pension Market in Focus 2014, table 4 and OECD, Pension Funds in Figures, 2015.
FIDUCIARY DUTY IN THE 21ST CENTURY

THE US INVESTMENT MARKET

The United States is home to the world’s largest insurance market and fund management industry, and to the world’s two largest stock exchanges, the NYSE and NASDAQ.

The American Federal pension system (the Old-Age, Survivors, and Disability Insurance program), which provides minimum income requirements, is primarily financed through social security taxes paid by employers and employees.

Beyond low income workers, defined benefit retirement plans continue to be the dominant form of pension coverage for public sector workers. In contrast, defined contribution plans (which include corporate pension plans as well as the traditional 401(k) plans) are the predominant plans offered to private sector employees.

The key legal regimes applicable to the different forms of institutional investor are:

- **Pension funds**: Private pension funds are governed under federal law by the Employee Retirement Income Security Act (1974) (ERISA), which is administered and enforced by the US Department of Labor. Public pension funds are governed by state laws. Most states have adopted the Uniform Prudent Investor Act (1992) (UPIA), which incorporates the modern prudent investor rule as set out in the Restatement (Third) of Trusts: Prudent Investor Rule (2006).

- **Mutual funds**: Mutual funds are corporations or business trusts administered for the benefit of their shareholders and are governed under state laws. In addition to state laws, mutual funds are also subject to the Investment Company Act (1940) and, as a consequence, fall under the jurisdiction of the Securities and Exchange Commission (SEC).

- **Insurance companies**: Insurance companies are governed predominantly by state laws, with ERISA being applicable to...
the extent that the company is providing services to employee benefit plans.

- **Non-profit corporations**: Non-profit corporations are governed by state law. The legislatures of 49 states plus Washington DC have adopted the Uniform Prudent Management of Institutional Funds Act (2006) (UPMIFA), which sets out the prudence standards for the management and investment of non-profit corporations. UPMIFA draws the bulk of its text from UPIA.

- **Private trusts**: Private trusts are also governed by state law. As with pension funds, UPIA articulates the investment standards for the trustees of the private trusts in those states that have adopted it.

- **Charitable trusts**: Charitable trusts are also governed by state law. As with non-profit corporations, UPMIFA articulates the investment standards for the trustees of the charitable trusts in those states that have adopted it.

The SEC has broad authority over all aspects of the securities industry. Its mission is to protect investors, to maintain fair, orderly, and efficient markets, and to facilitate capital formation.

**LAW/POLICY CHANGES SINCE FRESHFIELDS (2005)**

There have been a number of significant changes in the law since the 2005 Freshfields report, notably:

- The widespread adoption of UPMIFA, which has largely harmonised the rules applicable to institutions organised and operated exclusively for charitable purposes, including charitable trusts and non-profit corporations.

- The introduction in 2008 by the Department of Labor of two bulletins under ERISA, one on Economically Targeted Investments and one on Shareholder Rights.

- The introduction of SEC disclosure requirements on climate change and on conflict minerals.

**PRACTITIONER PERSPECTIVES**

**The Law and Fiduciary Duty**

**The Modern Prudent Investor Rule**

The starting point for discussions of fiduciary duty is generally taken to be the modern prudent investor rule. This has emerged from federal statutes, state statutes implementing uniform laws and state common law, and is generally defined by reference to the American Law Institute’s Restatement (Third) of Trusts: Prudent Investor Rule (2006). The rule is incorporated into ERISA, UPIA and UPMIFA. Under the rule, the standard of prudent investment includes the duty of loyalty and the duty to diversify investments. The rule requires that the prudence of an investment should be determined at the time it was made and not in hindsight. The rule also requires that investments are assessed in the context of their contribution to an investment portfolio as a whole.

“The literature on SRI is robust enough to say that there is a serious question around whether or not ESG issues are important to investment performance. This suggests that, at a minimum, due diligence processes must include assessment of the need to take account of these issues in investment decision-making.”

Larry Beeferman (Director, Pensions and Capital Stewardship Project, Labor and Worklife Program, Harvard Law School)

Interviewees commented that the modern prudent investor rule is not prescriptive. Rather it gives investment fiduciaries the flexibility to follow a wide range of diversification strategies, provided that their investment choices are made with appropriate skill, care and prudence and always made for the benefit of the plan participants and beneficiaries.
ERISA (1974)
ERISA defines the responsibilities of institutional investors entrusted with retirement assets. Chief among these is the obligation to always act to protect the interests of plan participants and beneficiaries.

ERISA, 29 USC § 1104(a): Prudent man standard of care
Subject to sections 1103(c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and:
A for the exclusive purpose of:
(i) providing benefits to participants and their beneficiaries; and
(ii) defraying reasonable expenses of administering the plan;
B with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and with like aims would use in the conduct of an enterprise of a like character and with like aims;
C by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
D in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter and subchapter III of this chapter.

“Legislation says that fiduciaries must invest for the sole interest of participants and beneficiaries. This obligation is generally expressed in financial terms given that the goal of these plans is to provide retirement benefits.”
Judith Mares (Deputy Assistant Secretary, Employee Benefits Security Administration, U.S. Department of Labor)

While ERISA formally only applies to private pension funds, it is important because many public funds follow its provisions, in particular in relation to the standards of care that are expected of fiduciaries. It should, however, also be recognised that, depending on the details of their charters and of relevant state regulation, public funds can often invest in areas such as infrastructure, social housing and local economic development.

UPMIFA (2006) and UPIA (1992)
The National Conference of Commissioners on Uniform State Laws drafted UPMIFA to update and replace the Uniform Management of Institutional Funds Act (UMIFA). With respect to the standard for investment fiduciaries, UPMIFA replaces the business judgment rule applied under UMIFA with the modern prudent investor rule.

Key Provisions of UPMIFA § 3
a) Subject to the intent of a donor expressed in a gift instrument, an institution, in managing and investing an institutional fund, shall consider the charitable purposes of the institution and the purposes of the institutional fund.

Lesserchu (Deputy Assistant Secretary, Department of Labor, U.S. Department of Labor)
While UPMIFA does not directly address ESG considerations, several of its provisions are relevant to fiduciary duties, in particular the requirements to consider the charitable purposes of the institution and the purposes of the institutional fund, and to consider, along with other factors such as the expected total return of the investment, ‘an asset’s special relationship or special value, if any, to the charitable purposes of the institution’.

That UPMIFA draws so heavily on UPIA, means that the rules applicable to charitable organisations are now largely the same as those that apply to non-charitable organisations (including private and public pension funds and mutual funds organised as trusts).

Department of Labor Guidance (2008)
ERISA created a standard of care requiring fiduciaries to act in the best interests of beneficiaries/members. In response to questions about what that meant for ESG issues, the Department of Labor issued a number of guidance documents in the mid-1990s that said that, all things being equal, investors could consider non-economic factors in their decisions, that it was acceptable for trade union funds to make investments that provided social benefits so long as these had similar financial characteristics to other equivalent investments, and that investors should vote their shareholdings in a considered manner.

In 2008, the Department of Labor introduced two new bulletins – one on Economically Targeted Investments and one on Shareholder Rights. The aim of these was to clarify the earlier guidance and to provide additional guidance on the processes that investors should follow when deciding how to vote their shareholdings.

“We suspect that, while neither of the Bulletins has had a particular effect on those investors who were already active in sustainable and responsible investment, they are discouraging to investors contemplating making their first commitments to responsible investment.”

Meg Voorhes (Director of Research, USSIF)

Some investors (e.g. the US Forum for Sustainable and Responsible Investment (USSIF) and its members) have been critical of the bulletins, arguing that: (a) they appear to have altered the ‘exclusive purpose rule’ by replacing the duty to impartially serve the interests of participants and beneficiaries with the duty to protect the ‘economic interests of the plan’, (b) they do not acknowledge the duty of impartiality to different categories of participants, (c) they actively discourage long-term risk management measures such as active ownership and voting by focusing on the short-term costs of these measures rather than a balanced assessment of the costs and benefits of these measures, and (d) they create a bias against green investments by not giving due account to their financial and risk mitigation contributions to wider portfolio performance.

In 2014, the Department of Labor started to research investors’ views on the 2008 Bulletins, to better understand what was needed in terms of regulatory guidance and to determine whether changes are needed.

Disclosure Requirements
In the US, all publicly listed companies are required to report on ‘material’ information, within the management discussion and analysis (MD&A) section of their 10-K Forms (or 20-F Forms for foreign filers). In 2010, the SEC issued Commission Guidance Regarding Disclosure Related to Climate Change, outlining how
existing regulations apply to the disclosure of risks related to climate change in regulatory filings. In 2012, following a mandate in the Dodd-Frank Act, the SEC adopted its final rule on conflict minerals which requires public companies to disclose information about their sourcing of certain metals from countries that have been ravaged by civil war and insurgencies.

“In our most recent survey of sustainable and responsible investment in the US, we asked respondents why they consider ESG issues in their investment analysis. Of the 91 asset owners that responded, 43% said that their fiduciary duty created a positive obligation to take action.”

Meg Voorhes (Director of Research, US SIF)

“One of the big changes since 2008 has been that the market awareness of the financial materiality of ESG issues has grown. Increasingly analysts are analysing and measuring the financial impacts of ESG issues.”

Judith Mares (Deputy Assistant Secretary, Employee Benefits Security Administration, U.S. Department of Labor)

Current Practice

According to the 2014 USSIF Report on sustainable, responsible and impact investment trends in the US, $1 in every $6 under professional management in the United States is invested using one or more ESG investment strategies (ethical screening, integration of ESG issues into investment research and decision-making processes, shareholder advocacy). The report pointed to significant increases in the number of asset owners and investment managers using these ESG strategies and to the increase over the previous two decades in the volume of assets being managed in this way.

“We are very clear that all our corporate governance engagement and voting activities must be directed towards protecting the value of investment assets, in line with our fiduciary duties. When we are considering action (engagement, voting, etc.) on governance issues, we critically review the literature and evidence to be sure that there is a clear link between the proposed action and investment value creation.”

Michael P. McCauley (Senior Officer, Investment Programs & Governance, Florida State Board of Administration (SBA))

In relation to engagement, there are no formal legal obligations on investors to be active owners. Voting rights are, however, recognised as fund assets, and funds must report on how they vote. Endowments, foundations and public plans tend to be more active on engagement than corporate plans.
Drivers for Action
Interviewees were optimistic that the number of investors using ESG investment strategies, in particular the integration of ESG issues into investment research and decision-making processes and shareholder advocacy, will increase over time. They pointed to a number of distinct drivers: the growing market awareness of the financial relevance of ESG issues, market understanding of the differences between ethical screening and ESG integration, better disclosures from corporations on their ESG performance, and wider societal trends such as customer interest in issues such as climate change and human rights.

“Courts, generally, do not want to second guess bad decisions. Rather, they are interested in whether the decisions were based on sensible decision-making processes. So, for example, a decision to exclude coal (e.g. because of concern that climate change policy may create stranded assets) based on credible assumptions and a robust decision-making process may be considered acceptable. If an asset owner does make such a decision, it must have the discipline to set out its beliefs, be prepared to review the outcomes achieved and have the willingness to change if the data or evidence changes.”

Brian Golob (Global General Counsel and Global Chief Compliance Officer, Russell Investment Group)

However, there was also a recognition that change is likely to be relatively slow and piecemeal. In part this is due to the barriers to progress (see below). However, interviewees cautioned that even if all of these barriers were addressed, the traditional interpretations of fiduciary duty (in particular, the emphasis on short-term performance, the definition of beneficiary interests as being exclusively defined in financial terms and the view that wider social or environmental issues should be not considered in investment decision-making) still represent major obstacles to change.

Barriers to Change
Interviewees pointed to a number of distinct barriers to progress:

- The lack of regulatory guidance or court decisions on how responsible investment aligns with fiduciary duty. Interviewees pointed to the importance of having clarity on (a) timeframes (or the definition of ‘long-term’), (b) the specific activities that should form part of investors’ approach to responsible investment, and (c) the issues that should be considered in investment research and decision-making processes.

- The advice being provided by legal advisers and investment consultants. Interviewees commented that advisers and consultants continue to argue for very narrow interpretations of fiduciary duty, and to stress that delivering short-term, financial performance is the key expectation of fiduciaries. This, in turn, acts as a brake on asset owners’ willingness to adopt long-term investment.

“US lawyers tend to see fiduciary duty in very narrow terms. They often think that ‘the lines are brighter than they actually are’, i.e. that there must be an exclusive focus on financial returns, and that they must be agnostic on ethical issues.”

Brian Golob (Global General Counsel and Global Chief Compliance Officer, Russell Investment Group)
Commonly held views about responsible investment. Among those identified by interviewees were the perceptions (or misperceptions) that responsible investing is prohibited under ERISA guidance, that taking account of ESG issues in investment practice goes against the fiduciary duty concepts of prudence and loyalty, that a focus on ESG issues negatively affects investment performance, and that responsible investment is the same as negative screening. This is particularly applicable to the private pension market.

The lack of knowledge on ESG issues among investment consultants and legal advisers. Interviewees commented that, because many investment consultants and legal advisers are not familiar with responsible investment, they tend to argue that responsible investment may violate ERISA’s exclusive purpose rule (often using the Department of Labor’s 2008 Bulletins to support this argument).

The lack of robust evidence on the relationship between environmental and social issues and investment performance. Interviewees did point to corporate governance as an issue where there is good academic research on the investment relevance of these issues, and where there has been legal clarification (e.g. in the Enron case) of governance expectations.

The weaknesses and inconsistencies in corporate reporting on environmental and social issues. This makes it difficult for investors to take account of these issues in their investment processes.

The lack of consensus among beneficiaries, or in wider society, on the ESG standards expected of companies.

The energy dependence of the US economy. This is particularly important in states where coal, oil and mining are economically important, where there is a perception that responsible investment may conflict with the state’s core economic interests.

“One of the obstacles to the Department of Labor taking a more prescriptive approach is that there is no standardised reporting on ESG issues. This makes it difficult to draw blanket conclusions on the financial implications of ESG issues.”

Judith Mares (Deputy Assistant Secretary, Employee Benefits Security Administration, U.S. Department of Labor)

RECOMMENDATIONS

In addition to the global recommendations, we recommend that:

The Department of Labor should:

- clarify that:
  - fiduciary responsibility requires a long-term, risk-adjusted approach to management of pension assets so as to deliver sustainable retirement benefits to participants and beneficiaries in an impartial manner;
  - asset owners should pay attention to long-term factors (including ESG issues) in their decision-making, and in the decision-making of their agents;
  - asset owners are expected to proactively engage with the companies and other entities in which they are invested;
  - and clarify that these actions are consistent with asset owners’ fiduciary duties.

- reissue its 2008 bulletins on Economically Targeted Investments and on Shareholder Rights, and:
  - clarify that asset owners’ duty is to impartially serve the interests of participants and beneficiaries;
  - clarify that the assessment of the costs and benefits of risk management measures such as active ownership should explicitly consider the long-term benefits of such measures;
• clarify that green investments can make important financial and risk mitigation contributions to investment portfolios.

• require asset owners to say how they integrate ESG issues into their investment decisions. As part of these requirements, the Department of Labor should commit to:
  • review progress annually;
  • explain how asset owners integrate ESG issues into their investment processes;
  • analyse how these commitments have affected the actions taken and the outcomes achieved (where the outcomes relate to both investment performance and to the ESG performance of the entities in which they are invested).

The New York Stock Exchange (NYSE) and Nasdaq, given their scale and influence, should strengthen their ESG disclosure requirements for companies, in accordance with their public commitment to the Sustainable Stock Exchanges (SSE) initiative to promote long-term sustainable investment and improved ESG disclosure and performance among companies listed on their exchange.

US Momentum Around the Role of ESG Factors in Long-Term Investment

In Winter 2015, the PRI will publish a report that highlights the increasing actions by US pension funds to address ESG factors in their investments. The document also debunks misconceptions relating to ERISA and clarifies that collaborative shareholder engagement is not Acting in Concert.
APPENDICES

INTERVIEWEES

From March to June 2015 the project team interviewed over 50 stakeholders – investors, policymakers, lawyers and regulators – to understand how fiduciary duty affects investment practice in each of the eight countries covered by the studies. For each country, the aim was to develop a clear understanding of current practice, challenges and trends. To ensure consistency between countries, we used a structured interview process to ensure that we covered the same subject areas in each interview.

We asked the asset owner interviewees about their approach to investment and, specifically, about how they take account of ESG issues in their investment processes and in their active ownership and engagement activities. We also asked them about how formal legal requirements and informal expectations around fiduciary duty affect their investment approach, and about how prevailing interpretations of fiduciary duty affect the wider investment market’s approach to ESG integration and active ownership. When we interviewed investment managers and service providers, we asked them about how their clients’ fiduciary duties and commitments to responsible investment were implemented in practice.

The regulators we interviewed were asked about the law in their country as it relates to fiduciary duty, about how they interpret and implement the law, and about how the law might be changed to encourage asset owners to take greater account of ESG issues in their investment processes. We asked similar questions of legal advisers but with a greater focus on the advice that they offer to their asset owner clients and on how these asset owners are responding to advice given.

<table>
<thead>
<tr>
<th>Name</th>
<th>Position/Title</th>
<th>Organization/Client</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alison Schneider</td>
<td>Senior Manager, Responsible Investing</td>
<td>Alberta Management Investment Corporation (AIMCo)</td>
<td>Canada</td>
</tr>
<tr>
<td>Amane Fujimoto</td>
<td>Corporate Accounting &amp; Disclosure Division, Planning and Coordination Bureau</td>
<td>Financial Services Agency</td>
<td>Japan</td>
</tr>
<tr>
<td>Andreas Hallermeier</td>
<td>Portfolio Manager</td>
<td>Bayerische Versorgungskammer</td>
<td>Germany</td>
</tr>
<tr>
<td>Anton Pillay</td>
<td>CEO</td>
<td>Coronation Fund Managers</td>
<td>South Africa</td>
</tr>
<tr>
<td>Bethan Livesey</td>
<td>Policy Officer</td>
<td>ShareAction</td>
<td>UK</td>
</tr>
<tr>
<td>Bozena Jankowska</td>
<td>Global Co-Head of ESG</td>
<td>Allianz Global Investors</td>
<td>Germany</td>
</tr>
<tr>
<td>Brian Golob</td>
<td>Global General Counsel &amp; CCO</td>
<td>Russell Investments</td>
<td>US</td>
</tr>
<tr>
<td>Bruno Couri</td>
<td>Secretário</td>
<td>Rio Bravo Investimentos</td>
<td>Brazil</td>
</tr>
<tr>
<td>Carolyn Morris</td>
<td>Senior Manager Policy Development</td>
<td>Australian Prudential Regulation Authority</td>
<td>Australia</td>
</tr>
<tr>
<td>Chris Hodge</td>
<td>Executive Director, Strategy, Financial Reporting Council</td>
<td>Financial Reporting Council</td>
<td>UK</td>
</tr>
<tr>
<td>Chris Davies</td>
<td>CEO</td>
<td>Telstra Super</td>
<td>Australia</td>
</tr>
<tr>
<td>Craig Roodt</td>
<td>Head of Investment Risk</td>
<td>Australian Prudential Regulation Authority</td>
<td>Australia</td>
</tr>
<tr>
<td>Dan Chornous</td>
<td>CIO</td>
<td>RBC Global Asset Management</td>
<td>Canada</td>
</tr>
<tr>
<td>Daniel Ingram</td>
<td>Head of Responsible Investment</td>
<td>BT Pension Scheme</td>
<td>UK</td>
</tr>
<tr>
<td>Daniel Simard</td>
<td>CEO</td>
<td>Bâtirente</td>
<td>Canada</td>
</tr>
<tr>
<td>Name</td>
<td>Title/Role</td>
<td>Organization/Agency</td>
<td>Country</td>
</tr>
<tr>
<td>-----------------------------</td>
<td>---------------------------------------------------------------------------</td>
<td>----------------------------------------------------------</td>
<td>-------------</td>
</tr>
<tr>
<td>Danielle Press</td>
<td>CEO</td>
<td>Equip Super</td>
<td>Australia</td>
</tr>
<tr>
<td>David Styles</td>
<td>Head of Corporate Governance and Stewardship</td>
<td>Financial Reporting Council</td>
<td>UK</td>
</tr>
<tr>
<td>Ed Waitzer</td>
<td>Partner</td>
<td>Stikeman Elliott LLP</td>
<td>Canada</td>
</tr>
<tr>
<td>Fernando Duarte Folle</td>
<td>Especialista em Previdência Complementar CGPE/DISUP</td>
<td>Superintendência Nacional de Previdência Complementar - PREVIC</td>
<td>Brazil</td>
</tr>
<tr>
<td>Fumito Kawanishi</td>
<td>Chairman</td>
<td>Secom Pension Fund</td>
<td>Japan</td>
</tr>
<tr>
<td>George Iguchi</td>
<td>Head of Corporate Governance, General Manager of Equity Investment Department</td>
<td>Nissay Asset Management Corporation</td>
<td>Japan</td>
</tr>
<tr>
<td>Hannine Drake</td>
<td>Senior Associate</td>
<td>Bowman Gilfillan</td>
<td>South Africa</td>
</tr>
<tr>
<td>Hiroichi Yagi</td>
<td>Managing Director</td>
<td>Secom Pension Fund</td>
<td>Japan</td>
</tr>
<tr>
<td>James Andrus</td>
<td>Portfolio Manager</td>
<td>CalPERS</td>
<td>US</td>
</tr>
<tr>
<td>Jonathan Grabel</td>
<td>CIO</td>
<td>Public Employees Retirement Association of New Mexico</td>
<td>US</td>
</tr>
<tr>
<td>José Carlos Doherty</td>
<td>CEO</td>
<td>ANBIMA</td>
<td>Brazil</td>
</tr>
<tr>
<td>Judith Mares</td>
<td>Deputy Assistant Secretary</td>
<td>US Department of Labor</td>
<td>US</td>
</tr>
<tr>
<td>Judy Cotte</td>
<td>V.P. &amp; Head, Corporate Governance &amp; Responsible Investment</td>
<td>RBC Global Asset Management</td>
<td>Canada</td>
</tr>
<tr>
<td>Juliane Hilf</td>
<td>Partner</td>
<td>Freshfields Bruckhaus Deringer</td>
<td>Germany</td>
</tr>
<tr>
<td>Karen Lockridge</td>
<td>Pension Actuary</td>
<td>Mercer</td>
<td>Canada</td>
</tr>
<tr>
<td>Katharine Preston</td>
<td>Manager, Responsible Investing, OPSEU Pension Trust, and Acting Chair of the PIAC Corporate Governance Committee</td>
<td>Pension Investment Association of Canada</td>
<td>Canada</td>
</tr>
<tr>
<td>Kazuhiro Okuma</td>
<td>Director, Environment and Economy Division</td>
<td>Ministry of Environment</td>
<td>Japan</td>
</tr>
<tr>
<td>Kirshni Totaram</td>
<td>Head of Institutional Business</td>
<td>Coronation Fund Managers</td>
<td>South Africa</td>
</tr>
<tr>
<td>Larry Beeferman</td>
<td>Director, Pensions and Capital Stewardship Project, Labor and Worklife Program</td>
<td>Harvard Law School</td>
<td>US</td>
</tr>
<tr>
<td>Luciana Burr</td>
<td>Partner</td>
<td>Rayes &amp; Fagundes Advogados Associados</td>
<td>Brazil</td>
</tr>
<tr>
<td>Lucy Tusa</td>
<td>Principal</td>
<td>Mercer</td>
<td>UK</td>
</tr>
<tr>
<td>Marcel Theroux</td>
<td>Partner</td>
<td>Mercer</td>
<td>Canada</td>
</tr>
<tr>
<td>Marcel Barros</td>
<td>Executive Director</td>
<td>PREVI</td>
<td>Brazil</td>
</tr>
<tr>
<td>Marcelo Seraphim</td>
<td>Pension Fund Specialist</td>
<td>Superintendência Nacional de Previdência Complementar - PREVIC</td>
<td>Brazil</td>
</tr>
<tr>
<td>Marguerite Mills</td>
<td>Director, General Counsel</td>
<td>Genesis Investment Management</td>
<td>UK</td>
</tr>
<tr>
<td>Mário Fleck</td>
<td>CEO</td>
<td>Rio Bravo Investimentos</td>
<td>Brazil</td>
</tr>
<tr>
<td>Name</td>
<td>Position</td>
<td>Organization/University</td>
<td>Country</td>
</tr>
<tr>
<td>----------------------</td>
<td>--------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------</td>
<td>-------------</td>
</tr>
<tr>
<td>Mark Chaloner</td>
<td>Assistant Director – Investments</td>
<td>West Midlands Pension Fund</td>
<td>UK</td>
</tr>
<tr>
<td>Meg Voorhes</td>
<td>Director of Research and Operations</td>
<td>US SIF</td>
<td>US</td>
</tr>
<tr>
<td>Mervyn E. King</td>
<td>Chair of the King Committee on Corporate Governance</td>
<td>Mervyn E King SC</td>
<td>South Africa</td>
</tr>
<tr>
<td>Michael McCauley</td>
<td>Senior Officer, Investment Programs &amp; Governance</td>
<td>Florida State Board of Admin</td>
<td>US</td>
</tr>
<tr>
<td>Normand Brouillet</td>
<td>Board Member</td>
<td>Bâtirente</td>
<td>Canada</td>
</tr>
<tr>
<td>Paul Watchman</td>
<td>Honorary Professor</td>
<td>School of Law, University of Glasgow</td>
<td>UK</td>
</tr>
<tr>
<td>Peet Maritz</td>
<td>Principal Officer</td>
<td>Transnet Pension Fund</td>
<td>South Africa</td>
</tr>
<tr>
<td>Rosemary Hunter</td>
<td>Deputy Executive Officer, Retirement Funds</td>
<td>Financial Services Board</td>
<td>South Africa</td>
</tr>
<tr>
<td>Sarah Barker</td>
<td>Special Counsel</td>
<td>Minter Ellison Lawyers</td>
<td>Australia</td>
</tr>
<tr>
<td>Simon Taylor</td>
<td>Senior Manager, Legal, Policy and Legislation</td>
<td>Australian Prudential Regulation Authority</td>
<td>Australia</td>
</tr>
<tr>
<td>Steve Waygood</td>
<td>Chief Responsible Investment Officer</td>
<td>Aviva Investors</td>
<td>UK</td>
</tr>
<tr>
<td>Steve Berexa</td>
<td>Senior Portfolio Manager and Global Head of Research</td>
<td>Allianz Global Investors</td>
<td>US</td>
</tr>
<tr>
<td>Tetsuo Kitagawa</td>
<td>Professor of Finance and Corporate Governance, Graduate School of International Management,</td>
<td>Aoyama Gakuin University</td>
<td>Japan</td>
</tr>
<tr>
<td>Thomas Neumann</td>
<td>Head of Investment Supervision, Federal Financial Supervisory Authority</td>
<td>BaFin (Bundesanstalt für Finanzdienstleistungsaufsicht)</td>
<td>Germany</td>
</tr>
</tbody>
</table>
GLOBAL PEER REVIEWERS

On 9 July 2015, the findings were presented in a series of public webinars. Over 180 PRI signatories, UNEPFI members and other stakeholders participated in these webinars.

From 14 to 29 July 2015, the project team coordinated a global peer review process, with the draft report being sent to an external panel of global peer reviewers, representing a mix of practitioners and stakeholders in each of the eight countries. A list of the individuals who provided comment on the draft report is provided below.

<table>
<thead>
<tr>
<th>Name</th>
<th>Institution/Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Justin Atkinson</td>
<td>Alliance Trust</td>
</tr>
<tr>
<td>José Carlos H. Doherty</td>
<td>ANBIMA</td>
</tr>
<tr>
<td>Claudia Kruse</td>
<td>APG</td>
</tr>
<tr>
<td>Hannine Drake</td>
<td>Bowman Gilfillan</td>
</tr>
<tr>
<td>James Andrus</td>
<td>CalPERS</td>
</tr>
<tr>
<td>Carlos Joly</td>
<td>Cambridge Institute for Sustainability Leadership</td>
</tr>
<tr>
<td>Natalie Smith</td>
<td>Client Earth</td>
</tr>
<tr>
<td>Bettina Kretschmer</td>
<td>European Commission DG ENV</td>
</tr>
<tr>
<td>Amane Fujimoto</td>
<td>Financial Services Agency (Japan)</td>
</tr>
<tr>
<td>Rosemary Hunter</td>
<td>Financial Services Board (South Africa)</td>
</tr>
<tr>
<td>Daniela Saltzman, Shalini Rao</td>
<td>Generation Foundation</td>
</tr>
<tr>
<td>Rob Lake</td>
<td>Rob Lake Advisors Ltd.</td>
</tr>
<tr>
<td>Bruce Duguid</td>
<td>Hermes Investment Management</td>
</tr>
<tr>
<td>Erik Breen, George Dallas</td>
<td>International Corporate Governance Network (ICGN)</td>
</tr>
<tr>
<td>Tom Powdrill</td>
<td>International Transport Workers' Federation</td>
</tr>
<tr>
<td>Rebecca O’Brien Radford</td>
<td>Loomis, Sayles &amp; Company</td>
</tr>
<tr>
<td>Randy Bauslaugh</td>
<td>McCarthy Tétrault</td>
</tr>
<tr>
<td>Sarah Barker</td>
<td>Minter Ellison</td>
</tr>
<tr>
<td>Anne-Maree O’Connor</td>
<td>New Zealand Super Fund</td>
</tr>
<tr>
<td>Marcelo Seraphim</td>
<td>PREVIC</td>
</tr>
<tr>
<td>Anne Wittman</td>
<td>SHARE</td>
</tr>
<tr>
<td>Bethan Livesey</td>
<td>ShareAction</td>
</tr>
<tr>
<td>Pierre Habbard</td>
<td>Trade Union Advisory Committee to the OECD</td>
</tr>
<tr>
<td>Axel Hesse</td>
<td>SD-M GmbH</td>
</tr>
<tr>
<td>Meg Voorhes</td>
<td>US SIF</td>
</tr>
<tr>
<td>Aditi Maheshwari, Alison Harwood, Fiona Elisabeth Stewart</td>
<td>World Bank Group / IFC</td>
</tr>
</tbody>
</table>
FURTHER READING

Readers wishing to understand the exact legal situation regarding fiduciary duty in a specific country should review the legal texts and case law relevant to that country, and may need to speak to legal practitioners to get a complete and robust assessment. For readers interested in reading more about the broad themes and issues raised in this report, the following are useful references:


http://www.reinhartlaw.com/Documents/art140402%20IIIS.pdf


DISCLAIMERS

UN Global Compact
This publication is intended strictly for learning purposes. The inclusion of company names and/or examples does not constitute an endorsement of the individual companies by the United Nations Global Compact. The material in this publication may be quoted and used provided there is proper attribution.

UNEP Inquiry and UNEP FI
The designations employed and the presentation of the material in this publication do not imply the expression of any opinion whatsoever on the part of the United Nations Environment Programme concerning the legal status of any country, territory, city or area or of its authorities, or concerning delimitation of its frontiers or boundaries. Moreover, the views expressed do not necessarily represent the decision or the stated policy of the United Nations Environment Programme, nor does citing of trade names or commercial processes constitute endorsement.

PRI
The information contained in this report is meant for the purposes of information only and is not intended to be investment, legal, tax or other advice, nor is it intended to be relied upon in making an investment or other decision. This report is provided with the understanding that the authors and publishers are not providing advice on legal, economic, investment or other professional issues and services. PRI Association and the PRI are not responsible for the content of websites and information resources that may be referenced in the report. The access provided to these sites or the provision of such information resources does not constitute an endorsement by PRI Association or the PRI of the information contained therein. Unless expressly stated otherwise, the opinions, recommendations, findings, interpretations and conclusions expressed in this report are those of the various contributors to the report and do not necessarily represent the views of PRI Association, the PRI or the signatories to the Principles for Responsible Investment. The inclusion of company examples does not in any way constitute an endorsement of these organisations by PRI Association, the PRI or the signatories to the Principles for Responsible Investment. While we have endeavoured to ensure that the information contained in this report has been obtained from reliable and up-to-date sources, the changing nature of statistics, laws, rules and regulations may result in delays, omissions or inaccuracies in information contained in this report. Neither PRI Association nor the PRI is responsible for any errors or omissions, or for any decision made or action taken based on information contained in this report or for any loss or damage arising from or caused by such decision or action. All information in this report is provided “as-is”, with no guarantee of completeness, accuracy, timeliness or of the results obtained from the use of this information, and without warranty of any kind, expressed or implied.
THE PRI’S SIX PRINCIPLES FOR RESPONSIBLE INVESTMENT

1. We will incorporate ESG issues into investment analysis and decision-making processes.

2. We will be active owners and incorporate ESG issues into our ownership policies and practices.

3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.

4. We will promote acceptance and implementation of the Principles within the investment industry.

5. We will work together to enhance our effectiveness in implementing the Principles.

6. We will each report on our activities and progress towards implementing the Principles.

About the United Nations Global Compact
The United Nations Global Compact is a call to companies everywhere to voluntarily align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate policies and practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with over 8,000 companies and 4,000 non-business signatories based in 160 countries.

For more information, see www.unglobalcompact.org

About UNEP Finance Initiative
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 Principles for Responsible Investment Initiative
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 1,400 signatories from over 50 countries representing US$59 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 Inquiry
The Inquiry into the Design of a Sustainable Financial System has been initiated by the United Nations Environment Programme to advance policy options to deliver a step change in the financial system’s effectiveness in mobilising capital towards a green and inclusive economy - in other words, sustainable development. Established in early 2014, it will publish its final report in the second half of 2015.

For more information, see www.unep.org/inquiry