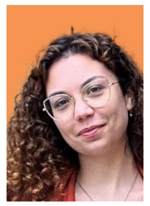
Event blog

Interpreting fiduciary duty

How do fiduciary duties and sustainability objectives intersect? This blog reviews insights from legal and investment experts following a session co-organised by *Pensions for Purpose*, *Phoenix Group* and the *Principles for Responsible Investment*

By Bruna Bauer



Addressing the common perception that fiduciary duties hinder the intentional pursuit of sustainability, this event examined perceived and actual barriers faced by investors in aligning financial objectives with sustainability outcomes. With insights from expert lawyers and investors, including **Nikki King** from *UN PRI*, **Callum Stewart** from *Standard Life*, **Carolyn Saunders** from *Dentons*, **Keith Guthrie** from *Cardano UK* and *NOW: Pensions*, and **Stuart O'Brien** from *Sackers*, the session explored ways to bridge the gap between governance constraints and the aspiration for sustainable financial objectives.

The legal framework for impact

Nikki King introduced 'A Legal Framework for Impact' (LFI), commissioned by the *UN PRI*, *Generation Foundation*, and *UN Environmental Programme Finance Initiative*, authored by *Freshfields Bruckhaus Derringer*. LFI aims to increase the global investment sector's response to environmental, social and governance (ESG) issues by shifting focus from managing ESG risks and opportunities to ensuring portfolios have positive sustainability impacts. The analysis investigated legal frameworks across 11 jurisdictions, including the UK, to determine their role in enabling investors to pursue sustainability goals alongside financial objectives, addressing the need for investments to align with global sustainability goals like the Paris Agreement.

What is investing for sustainability impact?

Investing for sustainability impact (IFSI) goes beyond standard ESG practices and focuses on the causes of portfolio risk. Unlike traditional ESG approaches, which adjust portfolios to mitigate specific risks – 'outside in' activities – IFSI employs tools such as stewardship, policy engagement and investment activities to influence the sustainability footprint of investees – 'inside out' activity. IFSI extends beyond the scope of traditional impact investing, which often focuses on financing specific projects, and may assist investors in discharging their duties.

Findings from LFI:

- Financial return is generally regarded as the primary purpose for investors.
- Investors generally have a legal obligation to consider pursuing sustainability impact goals where it can help achieve their financial objectives.
- In some cases, investors can also pursue sustainability impact goals for reasons other than financial returns (ie, in parallel to them).
- There are instances where investors are legally required to pursue sustainability impacts if the objective of the financial product commits them to do so.

Findings from the UK jurisdiction:

- The way UK investors understand and discharge their duties in practice may be discouraging them from pursuing positive sustainability impacts.
- Many UK investors remain hesitant to change their established practices and pursue sustainability impact goals, even when this is required to achieve financial objectives.

Recommendations based on the UK-specific report findings:

- Clarify when sustainability impact goals must, or can, be considered part of the duties of loyalty, care and prudence; as well as making clear the requirement to consider sustainability impacts includes an obligation to consider taking active steps to pursue sustainability impact goals where necessary to achieve scheme objectives.
- Ensure purpose-related requirements (also described as the duty to act in beneficiaries' best interest) include consideration of sustainability impact goals.
- Ensure stewardship powers are used to achieve sustainability impact goals, by addressing sustainability risks, and engaging in collaborative and policy activities relevant to investment purposes.

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The *Financial Markets Law Committee's* paper

Stuart O'Brien was involved in the *Financial Markets Law Committee's (FMLC)* report: Pension fund trustees and fiduciary duties – decision-making in the context of sustainability and the subject of climate change. Charlotte O'Leary of *Pensions for Purpose* invited Stuart to summarise the takeaways. The *FMLC*'s report clarifies fiduciary duties in the context of sustainability and climate factors. While it does not change the law, it offers valuable insights for trustees and advisers, by emphasising trustees' obligation to act in the best interest of the members. The paper clarifies ESG issues as financial factors.

The main points of the paper, according to Stuart:

1 No change in law – the law remains the same. Trustees can consider financially material factors, including sustainability, in their decision-making process. *FMLC* emphasises sustainability is indeed financially relevant, dispelling any doubts trustees may have had.

2 Consideration at multiple levels – financial factors, including ESG, must be evaluated on various levels:

- Asset level: assessing sustainability criteria of specific investments.
- Portfolio level: evaluating sustainability across the entirety of the asset strategy.
- Economy level: considering economy-wide sustainability issues affecting the pension fund.

3 Empowering trustees – *FMLC* encourages trustees to exercise their judgment and challenge advisers. Trustees are reminded of their decision-making responsibility and asked to challenge advice received, especially regarding sustainability and climate issues.

4 Recognition of market dynamics – trustees should acknowledge market prices might not reflect all relevant factors and sudden changes can occur. Trustees cannot simply diversify away from sustainability issues but must consider portfolio-wide and economy-wide impacts prudently.

5 Stewardship considerations – trustees may face climate change risks beyond the scope of their fund alone, known as systemic risks. Collaboration with advisers and investment managers to address these risks in coordination with other pension funds is encouraged.

6 Call for action – while the law remains unchanged, trustees are asked to broaden their focus on climate and sustainability issues. They should consider coordinated actions to address systemic and market-wide risks, going beyond their individual investments.

In summary, Stuart explained, while the legal framework remains stable, *FMLC* emphasises the need for trustees to adopt a more holistic approach towards sustainability and climate issues, fostering coordinated action to address broader systemic risks.

Empowering trustees

Callum Stewart provided a case study of *Standard Life*'s sustainable multi-asset solution, their primary workplace default pension arrangement. While it is utilised within their own master trust, it is also adopted across various trust structures and contract-based pensions. These principles resonate strongly across all these arrangements.

The crucial message he wants to convey is sustainable investing and financial investing are inseparable. Investment strategy begins with the members' needs. The main objective is helping grow pension savings for a secure retirement and, while financial returns are the priority for around 90% of members, they also prioritise avoiding harm from investments and aligning with environmental practices. Around three-quarters of members expect *Standard Life* to invest responsibly on their behalf. Consequently, the sustainable multi-asset solution is tailored to meet these expectations by prioritising financial goals while also considering environmental and social factors. After three years, the solution manages approximately £24bn across various pension schemes, supporting around two million members. It has also demonstrated competitive returns while integrating sustainability effectively.

Callum explained they achieve this by leveraging three sustainable investing principles:

1 Companies are analysed for long-term viability and excluded in the case of potential stranded asset risks, such as tobacco manufacturers or carbon-intensive energy companies.

2 *Standard Life*'s investments are directed towards companies committed to aligning with net-zero trajectories and those firms are rewarded with higher portfolio weightings.

3 The potential upside is considered by investing in organisations with significant revenue from climate tech solutions. In addition, *Standard Life* actively engage with companies through their stewardship team to drive positive change.

Viewing fiduciary duty in the long-term

Charlotte O'Leary raised a dilemma trustees face: reconciling fiduciary duty in the short-term compared to long-term time horizons. Callum, focusing on defined contribution (DC) workplace providers, mentioned the challenge of anchoring investment approaches on historical or current data when the world's landscape is destined to evolve significantly. Especially, for DC pension savers with decades for the investment to mature, Callum advocates designing forward-looking investment strategies. According to him, fiduciary duty lies not in justifying present approaches to individuals, but in making prudent investment decisions to benefit investors when they access their pension retirement savings. To illustrate the importance of this approach, he cited tobacco investments, showcasing the need to consider policy intervention risks in the climate transition, which could materialise in future. When embracing a longer time perspective, trustees should navigate fiduciary duty with foresight, while preparing for a world where change is inevitable and strategic decisions today may shape tomorrow's outcomes.

Questions and answers

Q: Is there a problem with the law or in the interpretation?

A: Carolyn Saunders:
"In my view, there's no issue with the law, and I appreciate much of the content in the *FMLC* paper. It reminds us to consider fiduciary duty as part of a trustee's normal decision-making process, focusing on the trust's purpose and what's relevant to each specific scheme. Fiduciary duty is flexible and I'm wary of calls for a more specific legislative definition, as it could limit this flexibility. The challenge often lies in trustees lacking confidence in implementing these principles, especially regarding what is financially material. The *FMLC* report offers valuable guidance, emphasising both qualitative and quantitative factors that trustees can consider. It's notable that larger schemes with ample resources and strong governance frameworks tend to excel in ESG implementation, showcasing the importance of confidence and resources in this process."

Q&A Keith Guthrie:
"The law regarding fiduciary duty is clear, but its interpretation is evolving. The *FMLC* paper provides a positive direction, highlighting the connection to broader impacts like systemic risk and economy-wide effects, moving beyond individual securities to consider the overall

"It's important to stress the law looks at the decision-making process trustees have followed, not the outcome – so behaviourally oriented rather than outcome focused. So, trustees should feel safe if they have made a decision following a proper process, having taken advice and having made a decision that was reasonable on the facts at the time the decision was made. It may or may not turn out to be correct. I think we've all admitted on here that climate is difficult. You only need to look at scenario analysis to immediately recognise that we don't know how things are going to play out. So, trustees should be making their decisions based on what they know at the time, what might be a reasonable decision at the time it's made and perhaps not feel too nervous that the kind of climate scenario they're trying to mitigate against may or may not happen."

STUART O'BRIEN

impact on members. However, this interpretation isn't uniformly adopted. Trustees, especially in pension funds like ours, aim to balance financial objectives with real-world impact objectives, recognising the systemic importance of these impacts on members. Achieving this balance has been challenging, requiring collaboration with different law firms. The question now is for this approach to become standard across the industry, with all advisers comfortable with this linkage. The *FMLC* report should help emphasise how considering systemic risks is not just an optional extra but a requirement in trustee decision-making.

Q&A Do you think a better alignment of actors within the system is needed alongside what we are asking of trustees?

Keith Guthrie:
"I am concerned about a potential disassociation within the investment process, particularly regarding split voting. Trustees may instruct investment managers to vote in a certain way but there may be a lack of alignment in how these managers engage with businesses. It's crucial for trustees to ensure alignment between investment engagement, voting policies and portfolio actions when selecting or retaining investment managers."

Q&A Carolyn Saunders:
"The industry must collaborate and acknowledge the complexity of sustainability issues. We must all admit there's much we still don't know. While it may be difficult for trustees to challenge advisers, it's essential for advisers to collaborate more extensively across the industry. Unfortunately, some prioritise market advantage over collaboration, hindering progress in addressing these pressing issues. We urgently need to change our behaviour and mindset toward sustainability."

Promoting collective action

Our participants gave personal commitments to pushing this agenda forward:

Callum – Considering sustainability factors across all investments, not just limited to equities but also fixed income and broader assets to address risks in various manifestations, particularly within the defined contribution (DC) workplace context.

Keith – Collaboration; fostering more collaborative efforts among team members and other consultants to drive forward sustainable practices and ensure their incorporation into client advice.

Stuart – Exploring how to integrate systemic risk into the understanding of fiduciary duty. He aims to enable trustees to consider systemic-wide risks within their fiduciary duties, possibly through collaborative engagement or seeking impactful opportunities without necessarily requiring a change in the law.

Carolyn – Promoting confidence in her trustee clients and providing them with comprehensive training to navigate decision-making in the sustainability space.

Charlotte – Empowering individuals within the ecosystem to understand systemic risks and opportunities.

More information

If you are interested in a conversation on this topic, please e-mail Karen Shackleton.

Click to read the synopsis and to view the Legal Framework for Impact slide deck.

Impact Lens

Our research includes published and commissioned reports. Through engagement with a range of stakeholders, we gather insights into the challenges of sustainable and impact investment. Impact Lens seeks to offer solutions and informed decisions on governance and investments. Coming soon, *Pensions for Purpose*'s latest Impact Lens research, 'Navigating diversity, equity and inclusion – an asset owner perspective,' sponsored by *Jupiter Asset Management*.

Help for asset owners

Pensions for Purpose offers asset owners bespoke pension committee training and facilitated workshops to help funds clarify their priorities, goals and how to achieve them.Our Knowledge Centre contains a huge collection of Thought Leadership articles from our members, with over 300 on Paris Alignment alone, as well as our own content.

● ***Bruna Bauer is an Intern at Pensions for Purpose and a graduate of the University of Glasgow***