

## Responsible investment and fiduciary duty

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Fiduciary duty is a contested term, with different definitions and different legal interpretations in different countries. This note sets out some of the key principles that underpin fiduciary duty, and discusses how fiduciary duty applies to investors, in the specific context of responsible investment.

Fiduciary obligations exist to ensure that those who manage other people's money act responsibly in the interests of savers (clients or beneficiaries), rather than serving their own interests. The nature of the fiduciary relationship means that a fiduciary is expected to be loyal to the person to whom he or she owes the duty. In particular, fiduciaries should not put their personal interests before the duty, should avoid conflicts to the extent possible (and, if they cannot be avoided, conflicts should be minimised, disclosed and carefully managed to prevent any breaches of loyalty obligations), should ensure that their fiduciary duty does not conflict with other legal duties or their own interests, and should not profit unreasonably from their fiduciary position.

Fiduciary duties are generally seen as requiring a higher standard of performance than those that are generally imposed in contracts. The most important fiduciary duties are:

- The duty of loyalty: That is, 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; and
- The duty of prudence: That is, fiduciaries should act with due care, skill and diligence, investing as an 'ordinary prudent man' would do.

### Who has fiduciary duties?

In investment, the most common fiduciaries are the trustees of trusts or pension funds. Beyond trustees, different jurisdictions have different interpretations of who exactly holds fiduciary obligations and who simply has duties of care. A comparison between the United Kingdom and the United States provides a good illustration of these differences. In the UK investment consultants do not generally define themselves as fiduciaries, whereas they are accepted as such in the United States. Moreover, in the United States, the Employee Retirement Income Security Act (ERISA) explicitly states that fiduciary liability attaches not only to trustees but also to anyone exercising discretion over investment plan assets. That is, under ERISA, asset managers have direct fiduciary obligations, and the appointment of asset managers is itself a fiduciary function. In

contrast, in the UK where fiduciary obligations are not defined in this way, some asset managers consider that their relationship with clients has a fiduciary character whereas others consider their relationship with clients to be defined by, and limited to, the contract between them.

This question of who holds fiduciary duties is likely to change. The shift in many countries to contract-based defined contribution (DC) pensions raises the question of who is responsible for protecting the interests of these savers. The specific question that policy makers will need to address is what duties are owed by insurance companies, asset managers and sponsoring organisations (i.e. employers) 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).

In the Netherlands, the board members of a pension fund have a statutory duty to - in the performance of their duties - follow the interests of the scheme members, deferred members, the pension beneficiaries and the employer, and the board must ensure that these parties can feel that the consideration of their interests is balanced.

In the Netherlands, a draft legislative proposal introduces a catch-all clause with a fiduciary duty for providers, advisors and intermediaries regarding - in short - investment properties, electronic payments, current accounts, loans, savings accounts and insurances. This draft proposal does not apply to investment firms. The proposal states that these financial services providers must observe the interests of the client carefully, an advisor must act in the interests of the client and these financial services providers must refrain from acts or omissions that have or may have negative consequences for their clients.

## **Key question: Can fiduciaries only consider financial factors in their decisions?**

In many jurisdictions, fiduciary duty is widely considered as imposing obligations on trustees or other fiduciaries to maximise investment returns. This narrow interpretation originated from the concern that trustees might put their personal ethical values over their fiduciary obligations to their clients or beneficiaries; this position appeared to be confirmed in the widely cited 1984 case of *Cowan v Scargill*, although this narrow interpretation has been challenged (see, for example, UNEP FI (2005), Fairpensions (2011), Kay (2012)). Apart from the legal implications of this case, the practical consequence have been that environmental, social and governance (ESG) risks have tended to be neglected in investment practice, that the maximisation of investment returns has focused on short term returns rather than seeking an appropriate balance between short and long-term returns, long-term and systemic risks to savers have been overlooked, and there has been relatively low demand for active ownership (e.g. engagement) directed at the creation of long-term sustainable investment value.

This is changing, driven by three factors. The first is that as the materiality of ESG issues has become clear meaning the argument that investors should not take account of these factors in investment practice has become less tenable. The ground-breaking 2005 Freshfields Report on fiduciary duty stated: "...in our opinion, it may be a breach of fiduciary duties to fail to take account of ESG considerations that are relevant and to give them appropriate weight, bearing in

mind that some important economic analysts and leading financial institutions are satisfied that a strong link between good ESG performance and good financial performance exists” (UNEP FI, 2005, p. 100).

The second is that expectations of investors are changing. As more and more investment organisations make commitments to responsible investment it is likely that the duties that investors owe their clients will also evolve to reflect these changes. That is, the interpretation of fiduciary duty, both in practice and at law, is likely to be much wider than at present.

The third is that the assumptions (e.g. in relation to the efficiency of markets) underlying the prevailing finance theories used during the last half of the 20th century have been questioned over the past decade, in particular as a result of the global financial crisis. The consequence is that investors are increasingly expected to take account of factors such as systemic risks and low probability/high consequence events (‘black swan’ events), as well as the insights from areas such as behavioural finance, in their investment decisions.

## Further reading

Readers wishing to understand the exact legal situation regarding fiduciary duty in a specific country should review legal texts and case law relevant to that country, and may need to speak to legal practitioners to get a complete and robust assessment.

There have been a number of major reports that have made the case for a wider interpretation of fiduciary duty. The most important of these are:

Department for Business, Innovation and Skills (2012), Ensuring Equity markets Support Long-term Growth: The Government Response to the Kay Review (November 2012) (Department for Business, Innovation and Skills, London).

<http://www.bis.gov.uk/assets/biscore/business-law/docs/e/12-1188-equity-markets-support-growth-response-to-kay-review>

DLA Piper UK (2006), ‘Responsible Investment and Exclusions’ (Letter from Jonathan Fenton (DLA Piper UK) to David Russell (Universities Superannuation Scheme, 8 September 2006).

<http://www.uss.co.uk/Documents/Legal%20advice%20to%20USS%20on%20RI%20from%20DLA%20Piper%20Sept06.pdf>

FairPensions (2011), Protecting our Best Interests: Rediscovering Fiduciary Obligation (Fairpensions, London).

[http://www.fairpensions.org.uk/sites/default/files/uploaded\\_files/fidduty/FPProtectingOurBestInterests.pdf](http://www.fairpensions.org.uk/sites/default/files/uploaded_files/fidduty/FPProtectingOurBestInterests.pdf)

James Hawley, Keith Johnson and Ed Waitzer (2011), ‘Reclaiming Fiduciary Duty Balance’.

[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1935068](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1935068)

Kay, J. (2012), The Kay Review of UK Equity Markets and Long-term Decision Making. Final Report – July 2012 (Department for Business, Innovation and Skills, London), Chapter 9 (pp. 65-69).

<http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-final-report.pdf>

United Nations Environment Programme Finance Initiative [UNEP FI] (2005), A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment (UNEP FI, Nairobi). [commonly referred to as the Freshfields Report]

[http://www.unepfi.org/fileadmin/documents/freshfields\\_legal\\_resp\\_20051123.pdf](http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf)

United Nations Environment Programme Finance Initiative [UNEP FI] (2009), Fiduciary Responsibility: Legal and practical aspects of integrating environmental, social and governance issues into institutional investment (UNEP FI, Nairobi).

<http://www.unepfi.org/fileadmin/documents/fiduciaryII.pdf>

## Acknowledgements

We would like to thank DLA Piper UK and Keith L. Johnson from Reinhart Boerner Van Deuren s.c. (US) for their comments on an earlier version of this briefing note.