

FIDUCIARY DUTY IN THE 21ST CENTURY

US ROADMAP

THE PROJECT

In January 2016, the Principles for Responsible Investment (PRI), the United Nations Environment Program Finance Initiative (UNEP FI) and The Generation Foundation launched a three-year project to clarify investors' obligations and duties in relation to the integration of environmental, social and governance (ESG) factors in investment practice and decision-making. This follows the publication in September 2015 of *Fiduciary Duty in the 21st Century* by the PRI, UNEP FI, UNEP Inquiry and UN Global Compact.

Fiduciary Duty in the 21st Century concluded that fiduciary duty requires investors to consider long-term value drivers in the prudent practice of fiduciary investors. ESG factors are a core part of such an assessment and should be integrated into investment decision-making processes, engagement with investee companies and interventions in public policy and regulation.

The project has three components:

- Working with investors, governments and intergovernmental organizations to develop and publish an international statement on investors' obligations and duties.
- Publishing roadmaps on the policy changes required to achieve full integration of ESG factors in investment practices across eight countries (US, Canada, Germany, UK, Japan, Australia, South Africa and Brazil).
- Extending research into fiduciary duties to major Asian markets: China (including Hong Kong), India, Korea, Malaysia and Singapore.

ESG integration is defined as the systematic and explicit inclusion of material ESG factors into investment analysis and investment decisions.

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This roadmap is prepared by the PRI, UNEP FI and The Generation Foundation and does not necessarily represent the views of interviewees and reviewers.

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Reinhart Institutional Investor Services	Keith Johnson	Chair
Russell Investments	Brian Golob	Global General Counsel & CCO
	Jean-David Larson	Director, Regulatory & Strategic Initiatives
	Dr Leola Ross	Director, Investment Research
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U.S. Securities and Exchange Commission	Mary Schapiro	Former Chair
University of Oregon	Susan Gary	Professor of Law
US SIF	Lisa Woll	CEO
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INTRODUCTION

This roadmap enables the PRI and UNEP FI to work with investors, stakeholders and policymakers in the US to ensure that regulatory frameworks reflect the modern interpretation of fiduciary duty. This interpretation requires investors to consider long-term value drivers, of which ESG factors are a core component, in investment processes and decision-making.

STAKEHOLDER FEEDBACK

This roadmap draws on over 30 interviews with stakeholders at different points in the US capital market (see list above). There were common themes in the feedback provided by stakeholders. These have formed the basis for the analysis and recommendations that follow and are summarized below.

Stakeholders noted that the proportion of assets under management in the US subject to ESG integration was growing rapidly¹. Investors were increasingly seeing the value to ESG analysis and were responding to a rising tide of client demand for ESG services. Several major US investors had become signatories to the Principles for Responsible Investment with many more seeking to join or enquiring about the principles². It was suggested that there remained misconceptions and knowledge gaps regarding ESG integration in the US³. These could be a source of scepticism and hold back its acceptance as a mainstream investment practice in parts of the US capital market. Stakeholders also sought to emphasize that ESG integration takes time to implement. It is a process and requires senior institutional support and education. In that context, it was noted that ESG integration methods were a subject of renewed focus for many investors and their industry organizations. Even where there was scepticism, there was growing interest.

Our stakeholders sought to make ESG integration an operational reality, rather than being perceived as an addition to an investor's compliance burden. This required two broad developments.

Firstly, the reporting of comparable, decision-relevant ESG information by corporations. Secondly, the incorporation of ESG factors and performance assessments into organizational processes and also arrangements with intermediaries, such as investment consultants and fund managers. It was broadly acknowledged that prudent investment practices were a function of sound and accountable governance structures.

In the context of increasing reliance on low-cost, passive investment strategies, stakeholders noted the importance of engagement as a core element of prudent investment practice and the mindful use of shareholder rights, such as proxy votes. Stakeholders wanted to see the quality and resourcing of engagement practices become a source of competitive differentiation between investment managers.

Litigation risk was identified as a key obstacle for schemes considering adjusting investment practices. Fiduciaries sought legal clarification of their discretion to integrate ESG and were concerned to avoid initiatives that might elevate scheme costs⁴.

Stakeholders further indicated that changes in underlying statutes were not required as they provided flexibility for ESG factors to be taken into account⁵. Several stakeholders were also concerned that seeking legislative change to make explicit reference to ESG considerations could take us "down the legal rabbit-hole"; distracting from a focus on prudent investment practice. Stakeholders were also generally resistant to expansions

1 As of 2014, 18% of investment assets under professional management in the US were subject to ESG analysis or filed ESG themed shareholder resolutions. USSIF Trends Report, 2014: http://www.ussif.org/store_category.asp?id=4

2 PRI Signatory Directory: <https://www.unpri.org/signatory-directory/?co=235&sta=&sti=&sts=&sa=join&si=join&ss=join&q=>

3 Misconceptions based on out-dated data and approaches which associated ESG with exclusively "ethical investment" and diminished returns. Both misconceptions which we address below.

4 Particularly cited in respect of ERISA governed plans

5 Confirming the analysis set out in Fiduciary Duty in the 21st Century

in regulatory remit. They noted that relying on regulatory guidance can be vulnerable to political considerations in a way that broad, market-practice-based assumptions about investment activity are not⁶. That analysis was counter-balanced by several stakeholders that identified well-framed regulatory guidance as a catalyst for plan fiduciaries to revisit governance structures and investment processes.

In developing this document, we have sought a balance between regulatory action and investment processes. We have sought to engage with the broad trends in the US capital market. We set out a series of recommendations.

SUMMARY RECOMMENDATIONS

- Overcoming misconceptions and knowledge-gaps on ESG integration
- Update Reg S-K to ensure high quality disclosure of material ESG information
- Guidance to trustees and plan sponsors on investment consultant services
- Updated legal guidance regarding fiduciary duty
- Enhanced framework for shareholder engagement with investee companies

- Revision of Investment Policy Statements
- Disclosure of investment practices
- Diversified governance structures
- Improved Stock Exchange guidance on ESG disclosures

The recommendations will support national stakeholders in implementing clear and accountable policy and practice that clarify investors' duties with regards to ESG factors. This work also sets the US capital market in a broader international context, as regulators and investors respond to a rapidly changing investing environment.

This roadmap makes recommendations for the US market to advance fiduciary investment practice. Following assessment of seven further markets (UK, Canada, Germany, Japan, Brazil, Australia and South Africa), the PRI, UNEP FI and The Generation Foundation will prioritise the areas to which we will contribute. In conducting this prioritisation, we will be mindful of work already underway by other stakeholder groups.

Our objective is a regulatory framework that reflects the modern interpretation of fiduciary duty; an interpretation which requires investors to consider long-term value drivers, of which ESG factors are a core component.

6 Citing ERISA guidance issued under different administrations as an example

THE EVOLVING LANDSCAPE FOR FIDUCIARY DUTY IN THE US

Our roadmap seeks to engage with the major trends in the US capital market as we advance the case and methods for ESG integration as a core element in fiduciary investment practice.

Developments in fiduciary duty⁷

Regulators and government agencies have confirmed interpretations relevant to fiduciary investment practice. In Interpretive Bulletin 2015-01 released in October 2015 (the ESG Bulletin⁸), the Department of Labor clarified that ESG factors can be part of the “primary analysis” of prudent investment decision-making by ERISA fiduciaries⁹. The ESG Bulletin may prove catalytic for the acceptance of ESG integration, particularly among skeptics. However, for many investors, the ESG Bulletin was simply a confirmatory statement of the appropriate content of prudent investment processes. In Notice 2015-62: Investments Made For Charitable Purposes, the Internal Revenue Service (IRS) provided that: “foundation managers may consider all relevant facts and circumstances, including the relationship between a particular investment and the foundation’s charitable purposes”. This helps to increase the freedom for foundations to pursue mission-driven investment in a manner consistent with their fiduciary duties.

We note that within the core fiduciary duties of prudence and loyalty are the duty of impartiality¹⁰ and the duty to monitor¹¹ which have become the subject of renewed focus. In seeking to balance the interests of plan participants, the duty of impartiality should

cause a fiduciary to consider the interests of beneficiaries who may not retire for 30 years as well as those who are current retirees. Fiduciaries are also required to subject their existing investments to critical analysis, understanding that the basis of an investment changes over time and should be monitored. This is particularly relevant given the known trends and uncertainties in the regulatory landscape and economic rationale for carbon intensive industries¹².

Structural changes in pension provision

The overall trend in US pension provision is one of risk transfer. Corporate defined benefit (DB) schemes are seeking to convert to defined contribution (DC) arrangements when their funding position allows. DC or IRA arrangements dominate new pension product offerings. This structural change makes the passage of the Fiduciary Rule¹³ regarding retirement advice particularly important for plan participants. DC plans are also seeking to reduce costs and plan options in response to cost based litigation against ERISA fiduciaries. We note that DB plans have significant advantages in terms of income replacement and beneficiary security which are generally not reflected in DC arrangements.

Beneficiary voice

Public scrutiny of the investment industry has increased with concern regarding its impact on society and the environment. We anticipate that beneficiaries, particularly millennials¹⁴, will want to engage with their retirement providers on environmental and social issues.¹⁵ This will add to the rising demand for ESG information and methods.

7 We do not restate the core elements of fiduciary duty in this document. See Fiduciary Duty in the 21st Century. We focus on under-emphasized aspects of fiduciary duty and recent developments relevant to its content and interpretation across regulatory contexts

8 Interpretive Bulletin Relating to the Fiduciary Standard under ERISA in Considering Economically Targeted Investments – also known as the ETI Bulletin

9 ERISA guidance has inferential weight for non-ERISA governed plans, as many share the same fiduciary standard

10 Varsity Corp v Howe et al., 516 U.S. 489 (1996)

11 Glenn Tibble, et al., Petitioners v Edison International, et al., 13-550 (2015)

12 Plan Sponsor, World’s Largest Coal Company Faces ERISA Suit: <http://www.plansponsor.com/Worlds-Largest-Coal-Company-Faces-ERISA-Suit/>

13 The revised Fiduciary Rule became effective on June 7, 2016 and will be applied from April 10, 2017 significantly extends the range of investment intermediaries whose advice would be subject to a higher fiduciary standard

14 RIA. Millennials, Women, and the Future of Responsible Investing: <https://riacanada.ca/millennials-women/>

15 Brookings Institute, How Millennials Could Upend Wall Street: http://www.brookings.edu/~-/media/research/files/papers/2014/05/millennials%20wall%20st/brookings_winogradv5.pdf

RECOMMENDATIONS

Our roadmap identifies strategic leverage points in the US investment market for advancing the modern interpretation of fiduciary duty. Our work also engages with the broad trends in the US market for retirement and investment products.

BUSINESS CASE – MISCONCEPTIONS, KNOWLEDGE-GAPS AND TRAINING

The incorporation of ESG factors into investment processes and research is a critical addition to the analytical tool-kit available to investors in assessing investee companies, constructing investment portfolios and driving enhanced returns¹⁶. ESG factors have been an essential part of long-term fundamental investment management processes for many years – without the use of the label “ESG”¹⁷. Management of ESG factors can also be a source of enhanced operational performance and financial prospects in investee companies¹⁸.

The PRI defines ESG integration as “the systematic and explicit inclusion of material ESG factors into investment analysis and investment decisions”. A recent PRI report indicates that investors can treat ESG factors in the same way as any other financial factors using existing quantitative methodologies¹⁹. Neglecting analysis of ESG factors may cause the mispricing of risk and poor asset allocation decisions. It is worth clarifying that, in our view, ESG integration does not necessarily involve a narrowing of the available investment universe (unlike negative screening)²⁰. Neither does it involve relegating the pursuit of a financial return to unrelated objectives (social or ethical). It does though provide investors with an expanded set of tools for evaluating the operational performance and financial prospects of investee companies. ESG analysis is

increasingly assisting investors to identify value-relevant factors undetected by out-dated financial-only analysis²¹.

The content of a prudent investment decision changes over time. We can see this in the expansion of the disclosure requirements under Regulation S-K²². Over recent decades that framework has expanded to include reporting on a corporation’s liquidity, capital structure, derivative instruments and off-balance sheet transactions. This reflects the evolving tools and techniques of prudent investment analysis. It is important to understand that ESG integration is less a product than it is part of the broader process and technology of investment analysis. Ultimately, the consideration of ESG factors has become one of the core characteristics of a prudent investment process.

Investors also face a number of systemic risks, such as the stability of systemically important financial institutions and the impacts of climate change. Climate change may significantly alter the investment rationale for particular sectors, industries and geographies and may have generalized negative impacts on economic output. Broadly diversified institutional investors are universal owners and, in effect, “own the market”, making diversification from generalized risks impossible. Given this, systemic risks, particularly those arising from ESG issues, should be pro-actively identified and assessed as part of prudent investment decision-making²³. Investors should adjust their analytical capacities to identify, integrate and provide transparency on their management of such long-term systemic risks²⁴.

It is important that ESG integration be broadly available as a tool of investment analysis. This makes fiduciary training and the publication of the investment case for ESG integration of strategic importance.

16 SBA Florida, Valuing the Vote: <https://www.sbafla.com/fsb/Portals/Internet/CorpGov/ReportsPublications/SBAValuingtheVote2015.pdf> & “Calpers Effect” Continues to Improve Company Performance: <https://www.calpers.ca.gov/page/newsroom/calpers-news/2014/company-performance>

17 Several investment managers said they considered all valuation-relevant factors, no matter what their origin –without specifically categorizing them under the ESG label

18 Robert Eccles, Ioannis Ioannou and George Serafeim. (2012) the Impact of Corporate Sustainability on Organization Processes and Performance: http://www.hbs.edu/faculty/Publication%20Files/SSRN-id1964011_6791edac-7daa-4603-a220-4a0c6c7a3f7a.pdf

19 PRI Reporting Framework 2016 Main Definitions: <https://www.unpri.org/page/pri-launches-esg-integration-guide-for-equity-investors>

20 For some investors, ESG integration is pursued in concert with negative screens.

21 ESG Research Works: <https://www.ft.com/content/b22c49c8-06e8-11e2-92ef-00144feabdc0>

22 Securities and Exchange Commission, Business and Financial Disclosure Required by Regulation S-K: <https://www.sec.gov/rules/concept/2016/33-10064.pdf>

23 Calstrs, Investment Policy and Management Plan: http://www.calstrs.com/sites/main/files/file-attachments/a_-_investment_policy_and_management_plan.pdf

24 Unhedgeable risk: How climate change sentiment impacts investment: <http://www.cisl.cam.ac.uk/publications/sustainable-finance-publications/unhedgeable-risk>

Recommendations

All trustee and fiduciary on-boarding procedures should embed skills and awareness of ESG analytics as part of the core competencies of trustees and scheme fiduciaries – and be set out as a requirement in fiduciary education. Trustee boards and plan fiduciaries should annually review their balance of skills and competencies²⁵; familiarity with ESG analytics and methodologies should be a fundamental part of that assessment. Investment consultants should advise their clients as to ESG risks and analysis.

Next steps

The PRI is working with signatories and industry stakeholders to develop ESG tool-kits and trustee training programs to raise awareness of ESG methodologies and benefits²⁶. This is part of work by a broad range of organisations such as SASB, CFA, Ceres and USSIF to raise awareness of ESG practices and develop methodologies to ease their adoption. To overcome misperceptions and knowledge-gaps, US investment consultants and asset managers should use a dedicated portion of their recurring client conferences to showcase ESG integration practices (methodologies, return attribution, engagement).

ENHANCED CORPORATE ESG DISCLOSURE – PRACTICAL, CREDIBLE, DECISION-RELEVANT

Conventional accounting information and reporting requirements conform to a set of generally accepted standards. Such standardization enables the disclosure of comparable information against which performance can be benchmarked and modelled. The lack of standardization of the reporting of ESG factors creates inconsistent reporting practices, raises the cost of production of such information and limits its usefulness to investors. The lack of a common materiality standard and the audience to which ESG information is addressed creates further complication for investors²⁷.

The SEC, through Regulation S-K, provides an existing corporate reporting architecture and a materiality standard familiar to the investment industry. The SEC provided Interpretative Guidance in 2010 that Regulation S-K required disclosure of material risks related to climate change²⁸. Investor feedback and the convening of the FSB Task Force on Climate-related Financial Disclosures indicate that reporting companies' response to this guidance was inadequate – with low quality or boilerplate disclosures being the norm. Existing guidance has not been sufficient to create a perceived industry requirement to disclose against ESG factors. Yet there is significant demand for standardized ESG reporting standards and an improvement in the quality and comparability of ESG reporting generally.

Recommendations

We recommend that the SEC update Regulation S-K to ensure high quality disclosure of ESG factors. The PRI has set out recommendations to the Commission in its response to the Concept Release on Regulation S-K²⁹.

Consistent with that response, we recommend that the following principles shape the Commission's requirements for corporate disclosures:

- ESG factors should be disclosed in the same wrapper as the annual report and the other outputs of conventional accounting practice, with clear links between ESG factors and the company's business model and risk factors.
- ESG factors should overtime be subject to assurance as with financial data. We suggest a phased introduction.
- Corporations should report using common performance metrics to allow for comparability, in particular, by industry, portfolio and across time-series.
- Corporations should disclose additional company-specific ESG risks and opportunities.

²⁵ In the same way that corporate boards are required to consider board competency under Sarbanes-Oxley

²⁶ PRI Investment Practices: <https://www.unpri.org/about/pri-teams/investment-practices>

²⁷ Though it is accepted that corporate information not directed at sophisticated investors may still be of relevance to an investor conducting ESG analysis

²⁸ Securities and Exchange Commission, Commission Guidance Regarding Disclosure Related to Climate Change: <https://www.sec.gov/rules/interp/2010/33-9106.pdf>

²⁹ Securities and Exchange Commission, Business and Financial Disclosure Required by Regulation S-K <https://www.sec.gov/rules/concept.shtml>

In addition, we note that SEC Staff Comment letters can drive disclosure practices both at the level of the registrant and the market generally. We recommend that the SEC continue to make the analysis set out in their Staff Comment Letters publicly available. In connection with the Regulation S-K consultation, we would welcome the Commission focusing staff effort on the analysis and improvement of disclosure of ESG information.

Next steps

Significant collaborations between investors and supportive organizations will continue to support the SEC following the close of the Regulation S-K concept release comment period³⁰. We expect significant work to follow on from the report by the FSB Task Force on Climate-related Financial Disclosures, supported by institutional investors and ESG standard setters to exert investor pressure to promote ESG disclosures by US issuers.

GUIDANCE ON CONSULTANT PROCESSES

Investment consultants strongly influence the investment strategies and resulting asset allocation decisions of US pension schemes. They also act as a selection mechanism in respect of investment managers and provide training to sponsors and trustees on investment approaches and emerging investment trends. Investment consultants are regulated under the Investment Advisers Act of 1940 (the Advisers Act) which provides for a fiduciary duty to provide disinterested advice to their clients³¹. Though decisions regarding asset allocation or manager selection are ultimately those of the relevant plan, in practice, trustees and plan sponsors lean heavily on the advice of their investment consultants – often seeming to interpret advice as instruction³². We note that under ERISA, an investment consultant is likely to be a plan fiduciary

as a result of the provision of investment advice to the plan³³. In this context, sponsors and trustees should be supported with guidance. Such guidance should outline methods for interacting with investment consultants to drive value and ensure that advice and investment processes are subject to searching analysis. Given the content and requirements of fiduciary duties, plan sponsors and trustees should be assisted in interrogating whether their consultants are reflecting the fiduciary duties against which they are held in the scope and content of their investment advice.

Practical recommendations on interactions between plan sponsors and trustees and investment consultants could be made, to ensure the consideration of material ESG issues in investment processes. Guidance could indicate that plan sponsors and trustees request and review their investment consultant's stated investment strategies; request an assessment of the depth of ESG skills of relevant staff (and their location within the investment consultant's business); and embed ESG reporting expectations into mandates and performance reviews of investment consultant practice – including the time-horizon against which investment choices are being made and assessed³⁴.

We note that as ERISA plans are regulated by the Department of Labor and the Advisers Act is overseen by the SEC, there is a role for joint guidance to be issued which would be of use to all plan sponsors and trustees. There is precedent for such joint guidance³⁵ – in which the SEC and the Department of Labor issued a series of questions for plan sponsors and trustees to ask their investment consultants on conflicts of interest³⁶. We also note that The Pensions Regulator in the United Kingdom³⁷ has recently concluded a consultation regarding expanding its suite of guidance to include scheme fiduciaries' interaction with service providers, such as investment consultants³⁸.

30 Towards a sustainable economy: <http://www.citizen.org/documents/SustainableEconomyReport.pdf>

31 In addition to disclosing conflicts of interest.

32 To an extent this reflects the expected interaction between investment professionals (as service providers) and lay-people (as clients) – where the expert can significantly influence client outlook

33 Section 3(21) ERISA

34 Further guidance is set out in - How Asset Owners Can Drive Responsible Investment: Beliefs, Strategies and Mandates (produced by the PRI in partnership with United Nations Environment Program – Finance Initiative and United Nations Global Compact)

35 Securities and Exchange Commission, Selecting and Monitoring Pension Consultants: Tips for Plan Fiduciaries: <https://www.sec.gov/investor/pubs/sponsortips.htm>

36 Department of Labor, Selecting and Monitoring Pension Consultants- Tips for Plan Fiduciaries: <https://www.dol.gov/ebsa/newsroom/fs053105.html>

37 Which has a somewhat similar remit to EBSA within the Department of Labor

38 The Pensions Regulator, 21st century trusteeship and governance discussion paper: <http://www.thepensionsregulator.gov.uk/doc-library/21st-century-trusteeship-and-governance-discussion-2016.aspx>

Recommendation and next steps

We expect key industry stakeholders to develop and build on existing guidance to plan sponsors and trustees in their interactions with investment consultants on ESG factors. Following international trends, we would expect US regulators overtime to adopt such guidance.

ADVISOR PRACTICE – LAWYERS

PRI released guidance in February 2016 by Morgan, Lewis and Bockius and Groom Law Group on fiduciary duty in the US reflecting the content of the ESG Bulletin³⁹. This is the start of a program to adapt the default legal guidance given to the investment community. The report, *Fiduciary Duty in the 21st Century*, identified out-dated and narrow legal interpretations of fiduciary duty as a significant barrier to ESG integration and our stakeholder engagement interviews have confirmed that legal guidance is a significant impediment to progress.

We seek to engage with the legal community to adjust the mainstream perception of the litigation risk for ESG integration. Litigation risk has often been cited as a reason not to integrate ESG. This is substantially informed by the volume of ERISA class-action cases brought against scheme fiduciaries in recent years. Though the causes of action were not associated with ESG, the volume of litigation has caused scheme fiduciaries to be reluctant in adopting new scheme practices. We consider that recent causes of action⁴⁰, legal commentary, particularly in the context of climate change⁴¹, and the volume of funds using ESG integration techniques are part of the context adjusting the balance of litigation risk. A lack of

integration of ESG factors into investment processes is emerging as a source of significant legal and financial risk⁴². We note that all professionals have a duty of care towards their clients to highlight matters of relevance to their business.

Recommendation and next steps

To engage with law firms that advise plan fiduciaries to raise awareness of ESG integration issues. We will collaborate with legal advisers to develop further legal guidance to clarify the legal risks arising from a lack of prudent management of ESG factors in investment portfolios.

SHAREHOLDER ENGAGEMENT

Shareholders play a critical role in corporate governance⁴³. Enhanced shareholder engagement has seen changes in board election practices, executive compensation and, in some instances, corporate strategy⁴⁴. Engagement assists shareholders in making informed voting decisions in respect of investee companies and has moved, in short-order, from the margins to the mainstream⁴⁵ - a year-round activity, not one simply precipitated by an annual general meeting or corporate crisis. Engagement is an instrument for creating long-term value and is a central element in the prudent oversight of investee companies.

We note that engagement on ESG issues with investee companies is the core ESG integration practice for many investors⁴⁶. ESG themes have proved a dominant topic for shareholder resolutions⁴⁷. These resolutions are now obtaining support from increasingly larger proportions of shareholders in voting returns⁴⁸.

39 PRI presents legal perspectives on addressing ESG factors under ERISA: <https://www.unpri.org/news/pri-presents-legal-perspectives-on-addressing-esg-factors-under-erisa>

40 Plan Sponsor, World's Largest Coal Company Faces ERISA Suit: <http://www.plansponsor.com/Worlds-Largest-Coal-Company-Faces-ERISA-Suit/>

41 Ignoring climate risk risks liability for pension fund trustees and fund managers: <http://www.6pumpcourt.co.uk/2016/07/ignoring-climate-risk-risks-liability-for-pension-fund-trustees-and-fund-managers-3/>

42 Peabody Settlement Shows Muscle of Law Now Aims at Exxon: <https://insideclimatenews.org/news/10112015/peabody-coal-climate-change-settlement-new-york-ag-exxon-subpoena-investigation>

43 U.S. Securities and Exchange Commission, Remarks at the 10th Annual Transatlantic Corporate Governance Dialogue: <https://www.sec.gov/News/Speech/Detail/Speech/1370540434901#VLv9i>

44 For example: the wide adoption of majority voting practices in director elections; board de-classification; and proxy access

45 Four takeaways from proxy season 2015: <http://www.ey.com/Gl/en/Issues/Governance-and-reporting/EY-four-takeaways-from-proxy-season-2015#company-investor-engagement>

46 Particularly for long-hold equity positions or passive, indexed investment vehicles

47 Submitting resolutions has been practiced by collaborative engagement forums for many years (eg ICCR, Ceres INCR).

48 Report on US Sustainable, Responsible and Impact Investing Trends: http://www.ussif.org/store_category.asp?id=4

Several well-informed guides on engagement have been published⁴⁹ and investors are becoming more assertive in reporting on their engagement practices⁵⁰. It is understood that best engagement practices⁵¹ may produce significant efficiencies for both investors and boards of investee companies⁵². In the context of these trends, we seek to enable the quality, consistency and outcomes from engagement with investee companies to be a source of competitive differentiation among asset managers and an indicator of best practice between asset owners.

Shareholder Rights Bulletin to be withdrawn:

We recommend that the Department of Labor withdraw and re-issue its Interpretive Bulletin from October 2008 (29 CFR 2509.08-1)⁵³ applicable to ERISA fiduciaries (the Shareholder Rights Bulletin). The Shareholder Rights Bulletin has had the effect of raising doubts as to the circumstances in which ERISA fiduciaries are able to engage with investee companies and vote proxies. Where many institutional investors have sought to engage with shareholder resolutions on ESG issues, stakeholders indicated that many ERISA investors have felt less able to do so. This is broadly the result of the Shareholder Rights Bulletin indicating that engagement and proxy use on environmental and social issues would be rare.

We note that in the ESG Bulletin issued in October 2015, the Department clarified that ESG factors could be part of the “primary analysis” of a prudent investment decision. In a series of advisory letters, the Department stated that the fiduciary duties (of prudence and loyalty) require plan fiduciaries “to vote proxies appurtenant to shares of stock” and that “the decision as to how proxies should

be voted with regard to the issues presented by the fact pattern are fiduciary acts of plan asset management”. The Shareholder Rights Bulletin’s seemingly hostile view on proxy voting and shareholder engagement with investee companies seems inconsistent with the Department’s guidance expressed in the ESG Bulletin and a drag on prudent engagement by ERISA fiduciaries.

Next steps

Stakeholders have expressed support for existing efforts to encourage the Department of Labor to withdraw the Shareholder Rights Bulletin.

Clarifying collaborative engagements:

We note that the SEC has sought to address corporations’ concerns regarding informal conversations it may convene with shareholders in a manner that avoids infringing Regulation FD⁵⁴. Investor uncertainty remains, however, around the extent to which shareholders may talk to each other regarding investee companies⁵⁵. This is a concern confirmed by PRI signatories and our stakeholder engagement interviews⁵⁶. Such interpretations can chill the extent of collaborative engagement that investors are comfortable to pursue regarding investee companies on ESG issues. The SEC has previously indicated that it was taking a closer look at Wolf Pack situations⁵⁷ - where activist hedge funds informally act in relation to an issuer without disclosure. We note that in the UK, the Financial Conduct Authority⁵⁸ has clarified in its code of conduct that conversations between investors are not acting in concert – enabling a more permissive regime for inter-shareholder dialogue regarding investee companies.

49 BlackRock & Ceres, 21st Century Engagement: <http://www.breckinridge.com/Ceres%20&%20BlackRock%2021st%20Century%20Engagement%20Guide.PDF> & How institutional investors should step up as owners: <http://www.mckinsey.com/business-functions/risk/our-insights/how-institutional-investors-should-step-up-as-owners>

50 SBA Florida, Corporate Governance Annual Summary 2015: http://www.sbafla.com/fsb/Portals/FSB/Content/CorporateGovernance/Reports/2015_SBACorporateGovernanceAnnualSummaryV2.pdf & State Street Global Advisors, Annual Stewardship Report 2015 Year End: <https://www.ssga.com/investment-topics/environmental-social-governance/2016/2015-Annual-Stewardship-Report.pdf>

51 SDX, What is the SDX Protocol?: <http://www.sdxprotocol.com/what-is-the-sdx-protocol/>

52 Gender Diversity and Corporate Performance: <https://publications.credit-suisse.com/tasks/render/file/index.cfm?fileid=88EC32A9-83E8-EB92-9D5A40FF69E66808> & Why diversity matters: <http://www.mckinsey.com/business-functions/organization/our-insights/why-diversity-matters>

53 Interpretive Bulletin Relating to Exercise of Shareholder Rights: <https://www.federalregister.gov/articles/2008/10/17/E8-24552/interpretive-bulletin-relating-to-exercise-of-shareholder-rights>

54 U.S. Securities and Exchange Commission, Section 101. Rule 100: General Rule Regarding Selective Disclosure: <https://www.sec.gov/divisions/corpfin/guidance/regfd-interp.htm>

55 Anti-trust rules and acting in concert disclosures among them

56 See also IRRGI: <http://irrcinstitute.org/wp-content/uploads/2015/09/engagement-between-corporations-and-investors-at-all-time-high1.pdf>

57 The SEC Doesn't Like it When Hedge Funds Talk to Each other: <https://www.bloomberg.com/view/articles/2015-06-05/the-sec-doesn-t-like-it-when-hedge-funds-talk-to-each-other>

58 Essentially the UK equivalent of the SEC

Next Steps

Stakeholders support confirmatory guidance on collaborative engagements between US investors.

Universal Proxy ballot:

The role of shareholder oversight should be affirmed and procedural obstacles removed wherever they exist. We note that the SEC's proxy access procedures were vacated. Proxy access has subsequently been addressed on a company-by-company basis and a broad market practice is developing around the appropriate thresholds at which proxy access can be obtained. In that context, we understand that the SEC has begun to review proposals for universal proxy ballots such that director candidates would be listed on the same proxy ballot form, rather than separate forms for management nominees and shareholder nominees⁵⁹.

Next steps

Institutional investors should continue to collaborate to support proposals for rules enabling universal proxy ballots⁶⁰.

Institutional Investor voluntary activity - best practice:

We recommend that institutional investors should provide public analysis of their engagement and stewardship activities⁶¹. To enable engagement to become a source of competitive differentiation, institutional investors should identify the resources that they have made available for engagement activities and the location of professionals within the business with responsibility for engagement activity.

REVISING INVESTMENT POLICY STATEMENTS

Investment Policy Statements are key documents in framing an institutional investor's outlook and also in signalling its preferences to service providers⁶². Not all schemes are required to have an Investment Policy Statement⁶³, but best practice suggests that schemes ought to have one. The content of such statements are an outgrowth of several factors⁶⁴ and set out scheme practice, procedures and objectives (which in our view should include the extent to which ESG integration is part of scheme practice).

Best practice suggests that where a plan has an Investment Policy Statement, it should be subject to routine annual review. In an investment environment which is far from static and where analytical tools and frameworks are constantly adjusting, institutional investors should make comprehensive reviews of Investment Policy Statements a priority. Following guidance by the Department of Labor and the IRS, we would expect ERISA, endowment and foundation fiduciaries to be considering comprehensive Investment Policy Statement reviews. We are aware that several State Plans have recently undertaken comprehensive investment belief and Investment Policy Statement review processes.

Developing or revisiting such statements is a deliberative process for fund fiduciaries, requiring time and extensive input from professional advisers. It can be a powerful tool for organizational learning and an opportunity to engage with the requirements fiduciary duty imposes on their institution.

59 SEC Chair says agency will propose 'universal proxy ballot' rules: <http://www.reuters.com/article/us-sec-proxy-rules-idUSKBN0P51V020150625>

60 CII Universal Proxy: http://www.cii.org/cii_universal_proxy

61 Having regard for capacity and resource constraints

62 Developing an Investment Policy Statement Under ERISA: <http://www.morganstanleyfa.com/public/facilityfiles/mssb866205/c92f47a9-e3a3-468a-8b88-2361defdd966.pdf>

63 For instance, an Investment Policy Statement is not required by ERISA though many plans have them. Public plans and foundations tend to have Investment Policy Statements, many of which are publicly available.

64 Fiduciary duties, the applicable regulatory regime, the time-horizon of the liabilities for which they are investing, product mix offered.

Recommendation and next steps

Stakeholders should work with investment consultants and fiduciary advisers to develop and publicize best-in-class Investment Policy Statements building on existing guidance. Industry bodies can also support and encourage Investment Policy Statement review by re-visiting guidance provided to member organizations⁶⁵. The PRI's work on developing investment strategies, investment policy statements and investment beliefs can also help frame and inform these processes⁶⁶.

Institutional investor voluntary activity – best practice:

Each institutional investor should set out a public statement of its understanding of its fiduciary responsibility and how this interacts with its investment practice. We note that several state public funds have such statements⁶⁷ and several foundations make their Investment Policy Statements public⁶⁸.

DISCLOSURE OF INVESTMENT PRACTICES

Regulators outside the US have increasingly required statements explaining ESG investment practices, such as the recent requirement by the Financial Services Commission of Ontario (FSCO) that pension funds disclose the extent to which they take account of ESG factors in investment processes⁶⁹. The FSCO notes that the decision to incorporate ESG factors is in line with pension

administrators' fiduciary duty to monitor and mitigate risk, and that transparency around the fund's policy is critical information for beneficiaries⁷⁰. Such disclosures have been a feature of UK pensions regulation for a decade⁷¹.

ERISA fiduciaries disclose a broad range of information annually on Form 5500 and are subject to record-keeping provisions. The Government Accountability Office has repeatedly examined the issue of effective disclosure by ERISA governed plans⁷² and identified extensions and improvements⁷³. We note that the Department of Labor has recently issued a proposed rule to significantly adjust the format and extent of annual disclosures by ERISA governed plans⁷⁴. The proposed rule is intended to “allow the Agencies and the interested public to monitor a larger number of pension plans and their asset allocations” and “lead to more competition and improved plan performance”. We welcome this initiative as the beginning of a broader process of expanded scheme disclosure and analysis – by both the Department, participants and plan analysis groups.

We note that Mutual Funds are required to disclose policies and procedures for voting shares in investee companies⁷⁵ and their record of proxy votes⁷⁶. Voting policies are often unspecific, with broad “case-by-case” voting flexibility. Attention is being given to simplifying the comparison of mutual fund voting practices to enable manager ratings to be widely developed⁷⁷. In this, as in other contexts, disclosure may also drive engagement. By providing for expanded disclosures in a prescribed format, regulators can enable inter-investor comparability and differentiation.

65 For instance, the Government Financial Officers Association (GFOA) has issued a Sample Investment Policy.

66 Crafting an investment strategy: <https://www.unpri.org/about/pri-teams/investment-practices>

67 CalPERS Beliefs: <https://www.calpers.ca.gov/docs/forms-publications/calpers-beliefs.pdf>

68 Glass Pockets Transparency Trends: <http://glasspockets.org/glasspockets-gallery/transparency-trends>

69 Financial Services Commission of Ontario FAQs – Statement of Investment Policies and Procedures: <https://www.fSCO.gov.on.ca/en/pensions/legislative/Pages/sipp.aspx#ESG>

70 Financial Services Commission of Ontario, Investment Guidance Notes: IGN-004: Environmental Social and Governance (ESG) Factors, <https://www.fSCO.gov.on.ca/en/pensions/policies/active/Documents/IGN-004.pdf>.

71 The Occupational Pension Schemes (Investment) Regulations 2005: <http://www.legislation.gov.uk/ukSI/2005/3378/regulation/2/made>

72 United States Government Accountability Office, Additional Transparency and Other Actions Needed in Connection with Proxy Voting: <http://www.gao.gov/assets/250/243646.pdf>

73 United States Government Accountability Office, Targeted Revisions Could Improve Usefulness of Form 5500 Information: <http://www.gao.gov/products/GAO-14-441>

74 Department of Labor EBSA, RIN 1210-2590: <https://s3.amazonaws.com/public-inspection.federalregister.gov/2016-14892.pdf>

75 Form N1-A

76 Form N-PX

77 Sustaining sustainability: What institutional investors should do next on ESG: <http://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/sustaining-sustainability-what-institutional-investors-should-do-next-on-esg?cid=other-emi-alt-mip-mck-oth-1606>

Recommendation and next steps

As part of expanded disclosure for ERISA governed plans, the Department of Labor should request disclosure of the extent to which long-term value drivers are incorporated into investment decisions and relations with scheme service providers – such as through asset manager mandates. The SEC should review the regime for disclosure of mutual fund voting to enhance comparability. We would support proposals for data tagging disclosures on Form N-PX⁷⁸. Stakeholders are working to identify and publicize the best international disclosure practices and the benefits of such disclosures

Institutional investor voluntary activity – best practice:

The vote is a market signal in a way private engagement with a corporation is not. Disclosure of rationale for cast votes enables an understanding of the disposition of asset owners and investment managers to proposals, both thematically and individually. It also contextualizes the application of investment policies which often contain wide “case by case” flexibility⁷⁹. As such, asset owners should report on voting decisions⁸⁰ and selectively provide rationale for voting decisions (such as for consequential votes and votes against management). Asset owners should selectively disclose

early proxy votes⁸¹, enabling other investors to use that information in determining their own voting rationale (without solicitation concerns)⁸².

DIVERSIFIED GOVERNANCE STRUCTURES

The quality of scheme governance structures is strongly correlated with the quality of scheme outcomes for beneficiaries. International examples suggest that governance structures that are diverse, independent and layered with participant representatives perform best. We note that there are US examples of diversified board structures – in various State Plans and in Taft-Hartley Plans⁸³. We note that there have been proposals in the US previously to insert a diversity of stakeholders into scheme governance structures⁸⁴.

Recommendation and next steps

The Department of Labor should conduct an industry study on ERISA plan governance structures and review the effectiveness, in terms of long-term investment management and beneficiary outcomes, of such structures. Stakeholders are working to identify and publicize the international and domestic evidence on the best performing governance structures for pension schemes.

78 Cost Effective Retrieval of Information by Investors: <https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac-recommendation-data-tagging.pdf>

79 SBA Florida - Corporate Governance Annual Summary: <http://www.sbafla.com/fsb/Governance.aspx>

80 BlackRock Investment Stewardship Guidelines, reports and position papers: <https://www.blackrock.com/corporate/en-br/about-us/investment-stewardship/voting-guidelines-reports-position-papers>

81 CalPERS Global Proxy Voting Decisions: <https://viewpoint.glasslewis.net/GlassLewisWebDisclosure/webdisclosure/search.aspx?qlpcustuserid=CAL095&WDFundGroupID=2774>

82 We note such disclosure may be hard to achieve within some asset owner governance structures and that some asset owners prefer to avoid such disclosure on principle.

83 Boards of trustees have equal representation between unions and management

84 Protecting America's Pensions Act 2002 – introduced in the Senate by Edward Kennedy - to balance in 401(k) governance boards

THE STOCK EXCHANGES

The major US exchanges have significant influence on the global listing market through ownership of non-US exchanges and listing a significant percentage of global market capitalization. Exchanges perform a vital function as information conduits and standard-setters, influencing the disclosure practices and expectations of both corporations and investors.

We note that both NYSE and NASDAQ are signatories to the UN Sustainable Stock Exchanges initiative. To date, 16 exchanges have introduced guidance⁸⁴ for reporting on ESG indicators with several more committed to produce guidance this year⁸⁵.

Guidance by exchanges can enhance the consistency and comparability of ESG information available to investors. Mandatory ESG disclosure is being adopted in a wide range of jurisdictions, responding to social expectations and investor demand. Exchange issued guidance on voluntary reporting of ESG indicators provides reporting companies with time to prepare for mandatory disclosure requirements⁸⁶.

Recommendation and next steps

NASDAQ and NYSE should provide guidance to their listed companies and investors to assess and report on ESG indicators to assist market preparation for mandatory ESG disclosures. Stakeholders will continue to work with the UN Sustainable Stock Exchanges initiative and other stakeholders to push for such guidance to be issued.

84 This includes exchanges that promote guidance from other standard setters or regulatory bodies, such as JSX adopting the King Code in South Africa.

85 The SSE Campaign to Close the Guidance Gap: <http://www.sseinitiative.org/engagement/esg-guidance/>

86 See recommendations regarding Regulation S-K above.

About the PRI

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 1,500 signatories from over 50 countries representing US\$62 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 FI

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 Generation Foundation

The Generation Foundation ('The Foundation') is the advocacy initiative of Generation Investment Management ('Generation'), a boutique investment manager founded in 2004. The Foundation was established alongside Generation in order to strengthen the case for Sustainable Capitalism. Its strategy in pursuit of this vision is to mobilise asset owners, asset managers, companies and other key participants in financial markets in support of the business case for Sustainable Capitalism, and to persuade them to allocate capital accordingly. For more information, see www.genfound.org.

CREDITS

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