



UNEP Finance Initiative
Innovative financing for sustainability

A legal framework for the integration of environmental, social and governance issues into institutional investment

Produced for the Asset Management Working Group
of the UNEP Finance Initiative

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FRESHFIELDS BRUCKHAUS DERINGER

Table of contents

FOREWORD	3
PARTICIPATING INSTITUTIONS	4
ACKNOWLEDGEMENTS	5
EXECUTIVE SUMMARY	6
DEFINITIONS	18
INSTITUTIONAL INVESTMENT: AN OVERVIEW	20
JURISDICTIONAL ANALYSES	
International	30
European Union	36
Australia	40
Canada	49
France	56
Germany	61
Italy	66
Japan	69
Spain	75
United Kingdom	82
United States	102
APPENDICES	117
DISCLAIMER	153

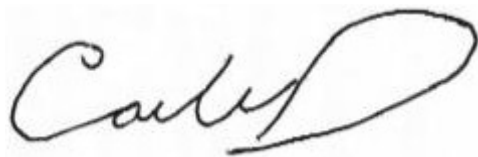
Foreword from the Asset Management Working Group Co-chairs

Institutional investors, pension fund trustees, asset managers, and investment advisors take their responsibilities seriously, generally putting their clients' or beneficiaries' interests before their own, as well they should. Fraud, self-dealing and illegal conduct do occur and when found out, as increasingly happens through internal controls or watchful regulators, it deserves unflinching penalties. Ethical conduct by financial market participants is often thought of as being synonymous with not breaking the law. But ethical conduct is more than not being crooked. That is why ethics exists, to help us decide what is right and what is good.

In our business, the investment business, ethical conduct extends beyond not breaking the law to properly interpreting what is in the best interests of the savers who are the ultimate beneficiaries of the institutional pools of money we are engaged to oversee or manage. This is where the interesting questions concerning fiduciary responsibility come to the fore: are the best interests of savers only to be defined as their financial interest? If so, in respect to which horizon? Are not the social and environmental interests of savers also to be taken into account? Indeed, many people wonder what good an extra percent or three of patrimony are worth if the society in which they are to enjoy retirement and in which their descendents will live deteriorates. Quality of life and quality of the environment are worth something, even if not, or particularly because, they are not reducible to financial percentages.

While not pretending to answer in the abstract what is right and what is good, we have sought to get expert opinion on the question whether the law restricts us, as asset managers, from seeking to attend to broadly accepted extra-financial interests of savers in conjunction with their financial interests. What we have in mind are certain social and environmental interests that find expression in diverse international treaties, norms, and declarations, particularly those emerging from the democratic deliberative processes of the United Nations. Furthermore, we have also asked whether fiduciary duty does not require us to take into account such considerations, in view of their materiality to equity pricing.

We thank Freshfields Bruckhaus Deringer and other contributors for the research and the report done pro bono publico. They responded with enthusiasm, speed, and resources to our request for advice and enlightenment in the area of fiduciary responsibility. We also thank the Secretariat of UNEP FI for their outstanding professional support. The Asset Management Working Group of the UNEP Finance Initiative consists of 13 asset managers and pension funds that exchange ideas and information and cooperate to advance the state of the art of responsible investment. We arrange seminars, sponsor broker research on the potential impacts of environmental, social and governance issues on equity pricing and generally seek to bring attention to the importance of these matters in our businesses and our industry. Freshfields has produced a superb study of the state of law in the US, Europe, Japan, Canada and Australia. We are sure their findings will be of broad interest and will help dispel the all-too-common misunderstanding that fiduciary responsibility is restricted by law, and solely and in a narrow sense, to seeking maximisation of financial returns.



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About Freshfields Bruckhaus Deringer

Freshfields Bruckhaus Deringer is a leading international law firm, with over 2,400 lawyers in 28 offices in 18 countries across Europe, Asia and the US. Our environmental, planning and regulatory law practice is widely recognised as a global leader in the field for the breadth and depth of its expertise. We also have a respected pro bono legal practice, which has enabled us to work in close cooperation with international governmental and non-governmental organisations.

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About the United Nations Environment Programme Finance Initiative (UNEP FI)

The United Nations Environment Programme Finance Initiative (UNEP FI) is a global partnership between the United Nations Environment Programme and the private financial sector. UNEP FI works closely with the 170 financial institutions that are signatories to the UNEP FI Statements, and a range of partner organisations, to develop and promote linkages between the environment, sustainability and financial performance. Through regional activities, a comprehensive work programme, training programmes and research, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

UNEP FI Asset Management Working Group (AMWG)

The Asset Management Working Group explores the association between environmental, social, and governance considerations and investment decision making. The Working Group consists of 13 asset managers with combined mandates of 1.7 trillion USD. Their clients are a spectrum of investor types with diverse portfolio allocations, for who investment decisions are made across a range of asset classes.

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Executive summary

The current value of assets managed by the investment industry worldwide is estimated at over US\$42 trillion. Pension fund investments in the US and the UK alone total around US\$7.4 trillion, while assets under management in the global mutual fund industry stood at \$14 trillion at the end of 2003.

The responsibility for deciding where the majority of these assets are invested lies not with the ultimate asset-owner, but rather with a small number of principals and their agents.

By influencing the way investments are made, the legal factors that inform the decisions made by this relatively small group have a profound effect on the behaviour of the entities in which these assets are invested and ultimately on the environments and societies with which these investment vehicles interact. For a number of years the United Nations Environment Programme Finance Initiative (UNEP FI) has been working with the financial services sector and its stakeholders to understand better this two-way interaction between investment and the environmental and social context in which it takes place. A major focus has been the work of UNEP FI's Asset Management Working Group (AMWG) on the materiality of environmental, social and governance (ESG) issues to securities valuation.¹

Despite the growing body of evidence that ESG issues can have a material impact on the financial performance of securities and an increased recognition of the importance of assessing ESG-related risks, those seeking a greater regard for ESG issues in investment decision-making often encounter resistance on the basis of a belief that institutional principals and their agents are legally prevented from taking account of such issues.

PURPOSE AND SCOPE

Our objective in preparing this report was to answer the following question put to us by the AMWG:

'Is the integration of environmental, social and governance issues into investment policy (including asset allocation, portfolio construction and stock-picking or bond-picking) voluntarily permitted, legally required or hampered by law and regulation; primarily as regards public and private pension funds, secondarily as regards insurance company reserves and mutual funds?'

We have also been asked to identify any common misconceptions against such integration.

In raising this question, the AMWG has indicated that it wishes to understand whether the commonly held view that fiduciary duties require a portfolio manager solely to pursue profit maximisation is a correct interpretation of the law or whether acting in the interests of beneficiaries can also incorporate other objectives. Those objectives might include the creation of institutional and societal conditions that favour, in the long term, the interests of beneficiaries, such as protecting the environment. The AMWG has also pointed out that different investment time horizons may dictate different investment analyses and strategies, in that long-term risks, such as risks associated with environmental damage, will be more relevant for long-term investors, and have asked to what extent the law recognises this.

The jurisdictions we have been asked to examine are:

- France;
- Germany;
- Italy;
- Japan;
- Spain;
- the UK; and
- the US.

¹ See www.unepfi.org/materiality/

We have also examined the position in Australia and Canada due to the level of academic interest in these jurisdictions and have outlined developments at the international and EU levels.

MODERN INVESTMENT MANAGEMENT

Like many professional activities, investment decision-making is an art rather than a science: there is no formula that guarantees a particular outcome. It is important to distinguish therefore between optimal decision-making and optimal decisions. The law is concerned with the former, as the latter can be arrived at only with hindsight. The oft-repeated caveat that ‘past returns are no indication of future performance’ is reflected in the legal duties imposed on investment decision-makers.

The law also acknowledges the predominance of the modern portfolio theory in investment management, in which portfolios of investments are selected based on their overall risk-reward characteristics rather than individual securities being selected on the basis of their individual risks and returns. Selecting an appropriately diversified portfolio is a crucial part of effective portfolio management. This is manifested in the balance that is sought to be struck between different types of assets, such as equities, bonds and cash, and different geographic spreads, industries or sectors.

Investment decision-making is also concerned with varying time horizons depending upon the investment involved. Pension fund investments in particular are intended to yield returns at some considerable distance into the future. It is therefore necessary when assessing investment decision-making against legal standards to have regard to the expected long-term performance of investments where the fund involved demands a return on investment over an extended horizon.

A SURVEY OF THE JURISDICTIONS: LEGAL LIMITS ON INVESTMENT DISCRETION

In each of the jurisdictions examined in this report, investment decision-makers retain some degree of discretion as to how they invest the funds they control. The scope of that discretion will vary: it may be narrow, in the case of 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 investment decision-maker, or it may be wide, as with many occupational pension funds, where very few express limits are typically placed on the way the fund may be managed. Further, some funds (such as le Fonds de réserve pour les retraites in France and the Japanese Welfare Pension Insurance) are subject to considerable state control and the discretion afforded to the decision-maker is narrowed by parameters set by government.

Within the scope of discretion left to the investment decision-maker by such express parameters, certain legal rules define investment decision-makers’ ability to integrate ESG considerations into their decision-making. It is these rules that are the subject of this report.

In the common law jurisdictions, which comprise the US, the UK, Australia and Canada, the rules are articulated in statute and in decisions of the courts. In the other jurisdictions, where civil law applies, the rules are code or statute-based. This means that in the common law jurisdictions some ‘rules’ are more flexible, being open to re-interpretation over time or when applied to new facts. The rules applicable in the civil law jurisdictions, by contrast, are more rigid as they are ‘frozen into codes and often rigid doctrine’² and are not generally interpreted by reference to decided cases but rather by reference to the principles and purposes behind their enactment.

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, for example) and general duties that must be fulfilled (such as duties to ensure investments are adequately diversified). In none of the jurisdictions do the rules exhaustively prescribe how decision-makers should go about integrating ESG considerations into their decisions; in most cases, it is left to decision-makers to determine the approach that will enable them to meet their legal obligations in the particular circumstances.

² See W.Tetley, “Mixed jurisdictions: common law vs civil law (codified and uncoded)” www.unidroit.org/english/publications/review/articles/1999-3.htm

Common law jurisdictions

Fiduciary duties are the key source of limits on the discretion of investment decision-makers in common law jurisdictions. The most important fiduciary duties are the duty to act prudently and the duty to act in accordance with the purpose for which investment powers are granted (also known as the duty of loyalty).

Broadly, fiduciary duties are duties imposed upon a person who exercises some discretionary power in the interests of another person in circumstances that give rise to a relationship of trust and confidence. Fiduciary duties are largely a product of case law. As common law jurisdictions often look to case law from other common law jurisdictions to inform their own law, there is a considerable degree of overlap in the law of fiduciary duties between these jurisdictions.

In the US, 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. The US position can be summarised as follows:

The US position – the modern prudent investor rule
<p>Institutional investors in the US are regulated through several strands of federal and state law. A common factor to almost all of this law is the application of the <i>modern prudent investor rule</i>, which has become the primary benchmark for investment decision-making – whether applied through federal statutes (notably ERISA, which governs private pension funds), state statutes implementing uniform laws or the development of state common law often with reference to the American Law Institute's <i>Third Restatement of Trusts (Prudent Investor Rule)</i>.</p> <p>The modern prudent investor rule, which incorporates both a duty of care and a duty of loyalty, emphasises modern portfolio theory and provides that:</p> <ul style="list-style-type: none">• investments are assessed not in isolation but in the context of their contribution to a total investment portfolio;• there is no duty to 'maximise' the return of individual investments, but instead a duty to implement an overall investment strategy that is rational and appropriate to the fund;• the investment portfolio must be diversified, unless it is prudent not to do so; and• the prudence of an investment should be assessed at the time the investment was made and not in hindsight. <p>The effect of the modern prudent investor rule is that institutional decision-makers are given latitude to follow a wide range of diversified investment strategies, provided their choice of investments is rational and economically defensible. The rule recognises that different investments play different roles within a balanced portfolio. Because there is no duty to maximise the return of individual investments, the prudence of any specific investment will only be assessed within the context of the overall investment strategy.</p> <p>There is accordingly no reason why investment strategies should not include investments with positive ESG characteristics. The important limiting requirement is that imposed by the duty of loyalty: all investment decisions must be motivated by the interests of the fund's beneficiaries and/or the purposes of the fund. No investment should be made purely to give effect to the personal views of the decision-maker. Instead, all considerations must be weighed and assessed in the context of their expected impact on the investment portfolio.</p> <p>Moreover, as with all considerations, ESG considerations must be taken into account wherever they are relevant to any aspect of the investment strategy (including general economic or political context, expected tax consequences, the role that each investment plays within the overall portfolio, expected risk and return, and the need for liquidity and/or capital appreciation). In addition, where the beneficiaries have expressed investment preferences in the fund instrument or otherwise, these preferences should also be taken into account.</p> <p>In short, there appears to be no bar to integrating ESG considerations into the day-to-day process of fund management, provided the focus is always on the beneficiaries/purposes of the fund and not on unrelated objectives.</p>

The position in the UK has been coloured by the misunderstood decision of *Cowan v Scargill*. This case, which concerned the proper investment of a pension trust, has led many investment decision-makers to believe that they are required to maximise financial returns on an investment-by-investment

basis and that the courts will overturn decisions made without that profit-maximisation objective in mind. Subject to certain statutory modifications, investment practice has been similarly informed in Australia and Canada where it is generally thought that *Cowan v Scargill* applies.

In our view, however, *Cowan v Scargill* cannot be relied upon to support the single-minded pursuit of profit maximisation, or indeed any general rule governing investment decision-making: it is a narrow case that turns on its own special facts.

Cowan v Scargill – a misunderstood UK authority

A number of landmark common law cases are frequently referred to by lawyers and other professionals but are rarely read and more often misunderstood. An example is *Donoghue v Stevenson*³ (the snail in the ginger-beer bottle), which laid the basis for the modern law of negligence. Those who have read the case will realise that it was never established that there was a snail in the bottle and that the original judgment has been misused over time to support all sorts of theories.⁴ To that landmark but misunderstood case must now be added the case of *Cowan v Scargill*.⁵ Megarry's⁶ decision has been distorted by commentators over time to support the view that it is unlawful for pension fund trustees to do anything but seek to maximise profits for their beneficiaries.

Notwithstanding his eminence as a jurist, Megarry was a sole judge sitting in the Chancery Division of the High Court, the lowest level of the higher English civil law courts.⁷ Read carefully, his decision stands for an uncontroversial position that trustees must act for the proper purpose of the trust, and not for extraneous purposes. Megarry himself took the unusual step of revisiting his judgment in print in 1989.⁸ He stated it was 'a dull case' that would not have been given any attention but for the lack of authority and added that in his opinion it decided nothing new. He explained that *Cowan v Scargill* did not support the thesis that profit maximisation alone was consistent with the fiduciary duties of a pension fund trustee. However, he has been ignored or misrepresented by those who wish to shun ESG, like the newspaper editor Dutton Peabody,⁹ who preferred to print the legend rather than the facts.

In any event, the case's practical relevance today is questionable. Fiduciary duties evolve over time according to changes in social norms and the values of society and, to a degree, technological and market changes. It is, for example, very unlikely that paying equal wages to men and women or subsidising public transport for the poor, elderly or disabled would be regarded as breaches of fiduciary duties in the 21st century but all were so regarded not very long ago.¹⁰

³ *Donoghue (or McAlister) v Stevenson* [1932] AC 562.

⁴ It should be noted that the appeal to the House of Lords in the *Donoghue v Stevenson* case was on the sole technical question whether, if the facts as averred by the claimant proved to be true, they would disclose a cause of action in the sense that the defendant who had produced the faulty product owed a duty of care to the claimant.

⁵ By a twist of fate, Freshfields acted for Cowan and the other trustees appointed to the Mineworkers' Pension Scheme by the National Coal Board in their action against Arthur Scargill and his co-trustees from the National Mineworkers' Union.

⁶ Megarry V-C, the judge who decided *Cowan v Scargill*.

⁷ The High Court is below both the Court of Appeal and the House of Lords to which appeals may be made from the High Court to more senior judges.

⁸ T.G. Youdan, *Equity, fiduciaries and trusts*, Scarborough, Carswell, 1989.

⁹ From 'The Man Who Shot Liberty Vallance' Paramount Pictures (1962).

¹⁰ *Roberts v Hopwood* [1925] AC 578: the court held that a local council was prohibited by its fiduciary duties to ratepayers from applying a standard minimum wage for all adult labour (thereby increasing wages for the lowest grade of female workers at a higher percentage rate than male workers of the same grade); *Attorney General v Guardians of the Poor Law Union of Tynemouth* [1930] 1 Ch 616: The court held that the Poor Law Union was prohibited by its fiduciary duties to ratepayers from releasing 'loans' given as assistance to striking coal workers; *Prescott v Birmingham Corporation* [1955] Ch 210: The court held that a local council was prohibited by its fiduciary duties to ratepayers from providing free travel to senior citizens; *Bromley London Borough Council v Greater London Council* [1982] 2 WLR 62: The court held that the Greater London Council was prohibited by its fiduciary duties from levying ratepayers in order to subsidise public transport.

The 21 years since *Cowan v Scargill* may not seem sufficient time to question the relevance of a case that has been widely regarded as a leading authority on investment management. However, the investment industry has changed dramatically in that period – in size, sophistication and complexity and in its understanding of how ESG issues affect investment and vice-versa – in ways that even Megarry could not have anticipated.

At most, *Cowan v Scargill* may be treated as endorsing the accepted rule that trustees exercising fiduciary investment powers must exercise those powers for the purpose for which they were granted. Where that purpose is to achieve a financial return, as in the case of the typical pension or mutual fund, securing a financial return must be the primary motivation behind investment decisions in respect of the fund. There may be one other respect in which *Cowan v Scargill* offers useful guidance: it confirms that fiduciary powers must be exercised in the interests of beneficiaries; as such, the interests of beneficiaries beyond financial return should be considered in arriving at investment decisions in certain circumstances. We discuss this further below.

As well as governing the purposes for which investment powers may be exercised, fiduciary duties also impose important requirements on decision-makers regarding the process that they must follow in reaching their decisions. This is also discussed in more detail below.

Civil law jurisdictions

Civil law jurisdictions do not recognise fiduciary duties as such, those duties being a product of the common law. However, investment decision-makers in these jurisdictions are subject to obligations that in many circumstances give rise to equivalent duties. These obligations are articulated in various statutory provisions regulating the conduct of investment decision-makers and in the government 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 a number of common themes can be identified. These include:

- a duty to act conscientiously in the interests of beneficiaries – this duty is expressed in different terms, with jurisdictions using terms such as ‘diligently’ (Spain), ‘professionally’ (Italy) or ‘prudently’ (France);
- a duty to seek profitability – this duty is expressly articulated in most of the civil law jurisdictions (with the exception of Japan) but in no jurisdiction is a particular level of profitability prescribed. In some jurisdictions the duty is qualified, such as in Germany where non-binding guidance indicates that the profit must be ‘sustainable’;
- recognition of the portfolio approach to modern investment, either in express terms or implicitly in the form of requirements to ensure adequate diversification, for example; and
- other duties in relation to liquidity and in some jurisdictions limits on the types of assets that may be selected for certain types of funds.

These duties are set out in more detail for each type of institutional investor in the duties diagrams below.

VALUE-DRIVEN AND VALUES-DRIVEN INVESTMENT

ESG considerations are capable of affecting investment decision-making in two distinct ways: they may affect the financial value to be ascribed to an investment as part of the decision-making process and they may be relevant to the objectives that investment decision-makers pursue.

Value: following the correct process

One element of the law governing investment decision-making that is common to all the jurisdictions is the requirement that decision-makers follow the correct process in reaching their decisions. In the common law jurisdictions, this requirement flows from the fiduciary duties of prudence and in the civil law jurisdictions, the duty to seek profitability and otherwise manage investments conscientiously in the interests of beneficiaries. Conforming with the correct process requires decision-makers to have regard to all considerations relevant to the decision, including those that impact upon value. In our view, decision-makers are required to have regard (at some level) to ESG considerations in every

decision they make. This is because there is a body of credible evidence demonstrating that such considerations often have a role to play in the proper analysis of investment *value*. As such they cannot be ignored, because doing so may result in investments being given an inappropriate value.¹¹

Taking account of ESG considerations does not mean that each consideration or each category of considerations is to be given the same weight or that decision-makers must agree the weight to be given to each consideration. There will inevitably be differences as to how considerations are to be defined and analysed. In some cases, the decision-maker may ultimately conclude that the ESG considerations relevant to a particular investment do not have a material impact upon financial performance. Such doctrinal differences do not justify a failure to identify such considerations and then assess their weight, however.

Further, it is increasingly difficult for investment decision-makers to claim that ESG considerations are too difficult to quantify when they readily quantify business goodwill and other equivalently nebulous intangibles:

‘Essentially the problem of intangibles can be reduced to the difference between quantitative and qualitative data. Accounting standards are not set in stone, and have evolved and changed over time. It is imperative that accounting standards and systems are altered to account for such intangibles.’¹²

A majority of the jurisdictions have legislated (or are expected to do so shortly) to require investment decision-makers, particularly in the pensions context, to disclose the extent to which they take ESG considerations into account (see table below). Such legislative endorsement of the relevance of ESG considerations to investment decision-making constitutes an important additional factor in favour of the view that decision-makers must have regard to ESG considerations at some level, even if they are ultimately given little or no weight.

Jurisdictions where ESG disclosure obligations apply	
Australia	✓
Canada	
France	✓
Germany	✓
Italy	✓ pending
Japan	
Spain	
UK	✓
US	

Values: pursuing a proper objective

Where they apply, fiduciary duties restrict the objectives that investment decision-makers may pursue. Investment decision-makers must act only in the interests of the beneficiaries for whom they act and in

¹¹ Climate change is an obvious example of an environmental consideration that is recognised as affecting value. Following the recent release of a report by Mercer Investment Consulting noting the financial impact that climate change has already had on companies’ costs, revenues, assets and liabilities, the UK Carbon Trust expressed the view that ‘Pension fund trustees have a duty to address the financial risk posed by climate change when making investment decisions.’ Carbon Trust, ‘A Climate for Change: A Trustee’s Guide to Understanding and Addressing Climate Risk’ www.thecarbontrust.co.uk.

¹² Howard Pearce, Head of Environmental Finance and Pension Management, Environment Agency, interviewed by Freshfields Bruckhaus Deringer on 11 July 2005.

accordance with the terms of the trust. Where the purpose of their investment power is to seek a financial return for the beneficiaries, as in the case of financial trusts such as most pensions, decision-makers must treat this as their overriding objective when making decisions in relation to the funds they control. This does not, however, require the pursuit of profit maximisation on an investment-by-investment basis as is often argued in the UK. Such an assertion arises from case law that we regard as no longer reliable. Rather, the US approach, which focuses on the returns realised across a well-managed portfolio as part of a rational investment strategy, appears to better reflect modern investment reality and is likely to be the approach a UK court would follow today.

There are strong similarities between the law in the common law jurisdictions and the law in the civil law jurisdictions on the issue of pursuing proper objectives. Like the common law duty to act for a proper purpose under a trust, all the civil law jurisdictions have rules in some form requiring decision-makers to act in the 'interests' of the ultimate beneficiaries.

The duty to act in the interests of the beneficiaries means that no investment decision should be made solely in the interests of or to give effect to the personal views of the decision-maker. However, a decision-maker may integrate ESG considerations into an investment decision to give effect to the views of the beneficiaries in relation to matters beyond financial return. Courts in the UK have recognised that trusts such as charities are entitled to exclude investments that conflict with their values and that the concept of beneficiaries' 'best interests' under a general pension trust may extend beyond their financial interests to include their 'views on moral and social matters'. In a similar way, US law¹³ permits investments to be excluded where the beneficiaries so consent.

A decision-maker who chooses to exclude an investment or category of investments on this basis will need to be able to point to a consensus amongst the beneficiaries in support of the exclusion. There are clear practical difficulties involved in identifying such a consensus by empirical means. Whilst there is little legal guidance directly on point, it can also be argued that even in the absence of such express consensus, there will be a class of investments that a decision-maker is entitled to avoid on the grounds that their ESG characteristics are likely to make them so repugnant to beneficiaries that they should not be invested in, regardless of the financial return that they are expected to bring. It is not possible to define the parameters of this class, but it might include investments that are linked to clear breaches of widely recognised norms, such as conventions on the elimination of child labour.

There may also be cases where a decision-maker has exhausted the analysis of financial criteria, including value-related ESG considerations, in making an investment decision and is still left with a number of alternatives, all of equal attractiveness from the point of view of the overall investment strategy being pursued. In those cases, the decision-maker would be entitled to select one alternative on the basis of its non-value-related ESG characteristics, without thereby being in breach of his or her fiduciary duties or civil law obligations.

FUTURE DIRECTIONS

This report has identified a number of developments that may provide guidance as to the likely future direction of law in this area. Most notable among these are:

- the Canadian province of Manitoba's legislative reform expressly allowing trustees to look to non-financial criteria to prepare an investment policy without breaching their fiduciary duties, providing certain prudence requirements are met; and
- the integration of ESG criteria, including the social and environmental behaviour of companies being considered for investment, into the investment management mandate issued to fund managers by the French retirement reserve fund.

These developments reinforce investment decision-makers' ability to integrate ESG considerations into their decision-making. Policymakers will likely come under increasing pressure to introduce reforms of this kind in other jurisdictions, given the growing demand for ESG-conscious investing from both

¹³ There is no clear guidance available in the civil law jurisdictions on this point.

the beneficiaries to whom principals and their agents are legally responsible and from the wider community.

CONCLUSIONS

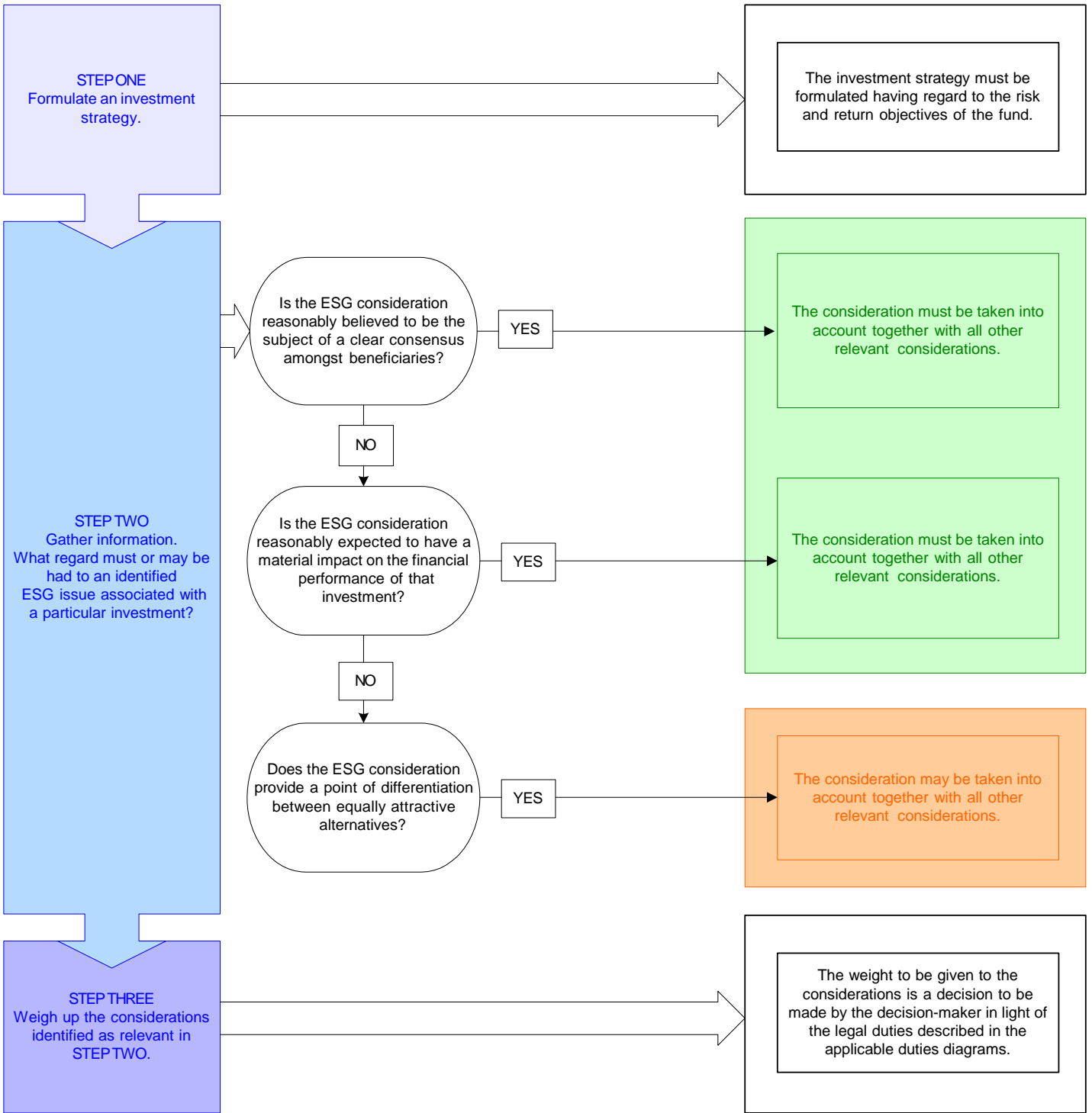
Conventional investment analysis focuses on *value*, in the sense of financial performance. As we note above, the links between ESG factors and financial performance are increasingly being recognised. On that basis, integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions.

It is also arguable that ESG considerations must be integrated into an investment decision where a consensus (express or in certain circumstances implied) amongst the beneficiaries mandates a particular investment strategy and may be integrated into an investment decision where a decision-maker is required to decide between a number of value-neutral alternatives.

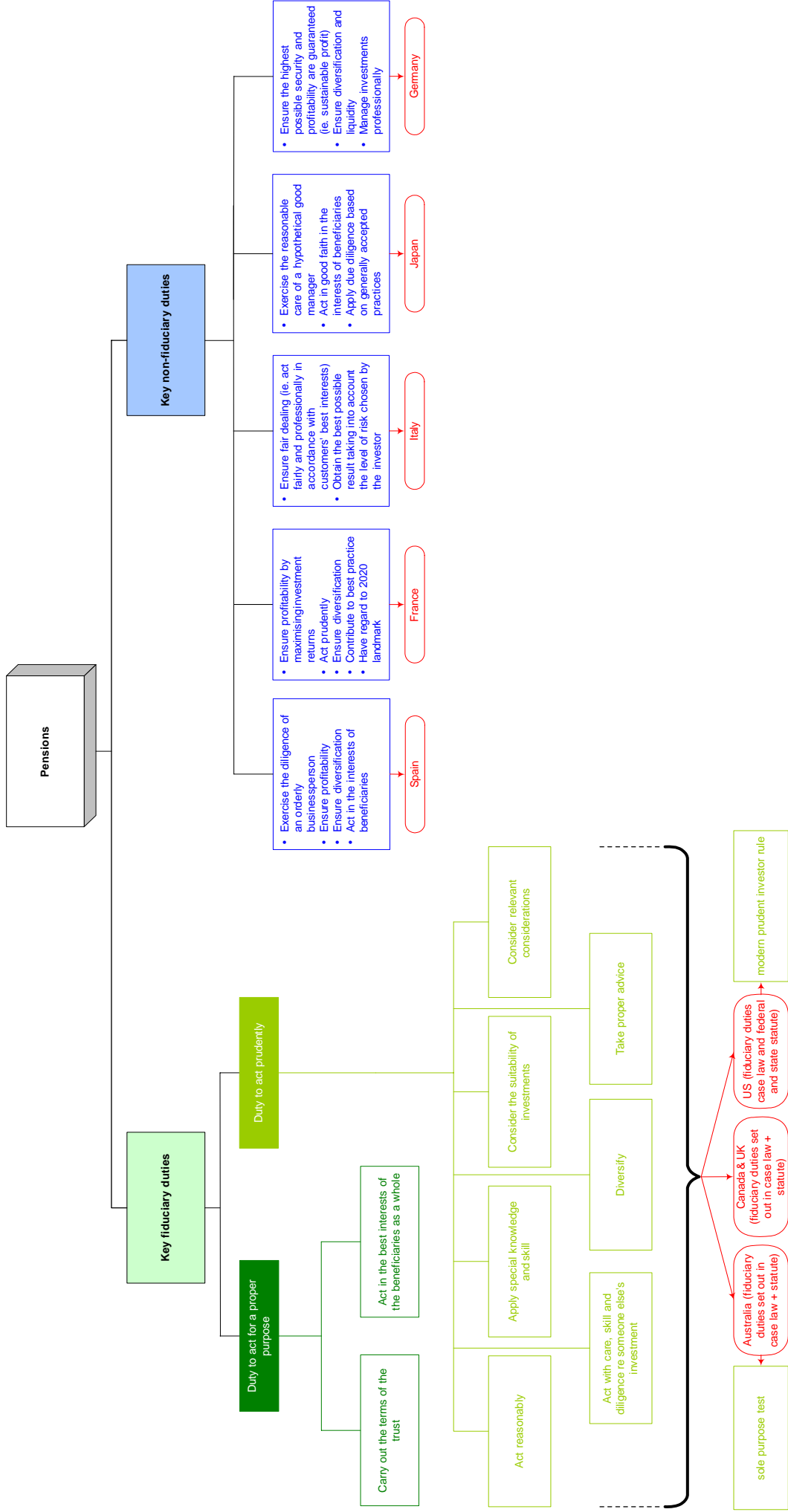
The flow chart below is intended to show the process involved in taking ESG considerations into account.

In all jurisdictions, investment decisions will not be assessed with the benefit of hindsight, but against reasonable standards of decision-making taking into account the information available to the decision-maker at the time of the decision. Provided that all relevant considerations have been taken into account, the weight that the decision-maker gives to each consideration or category of consideration is left to the discretion of the investment manager alone.

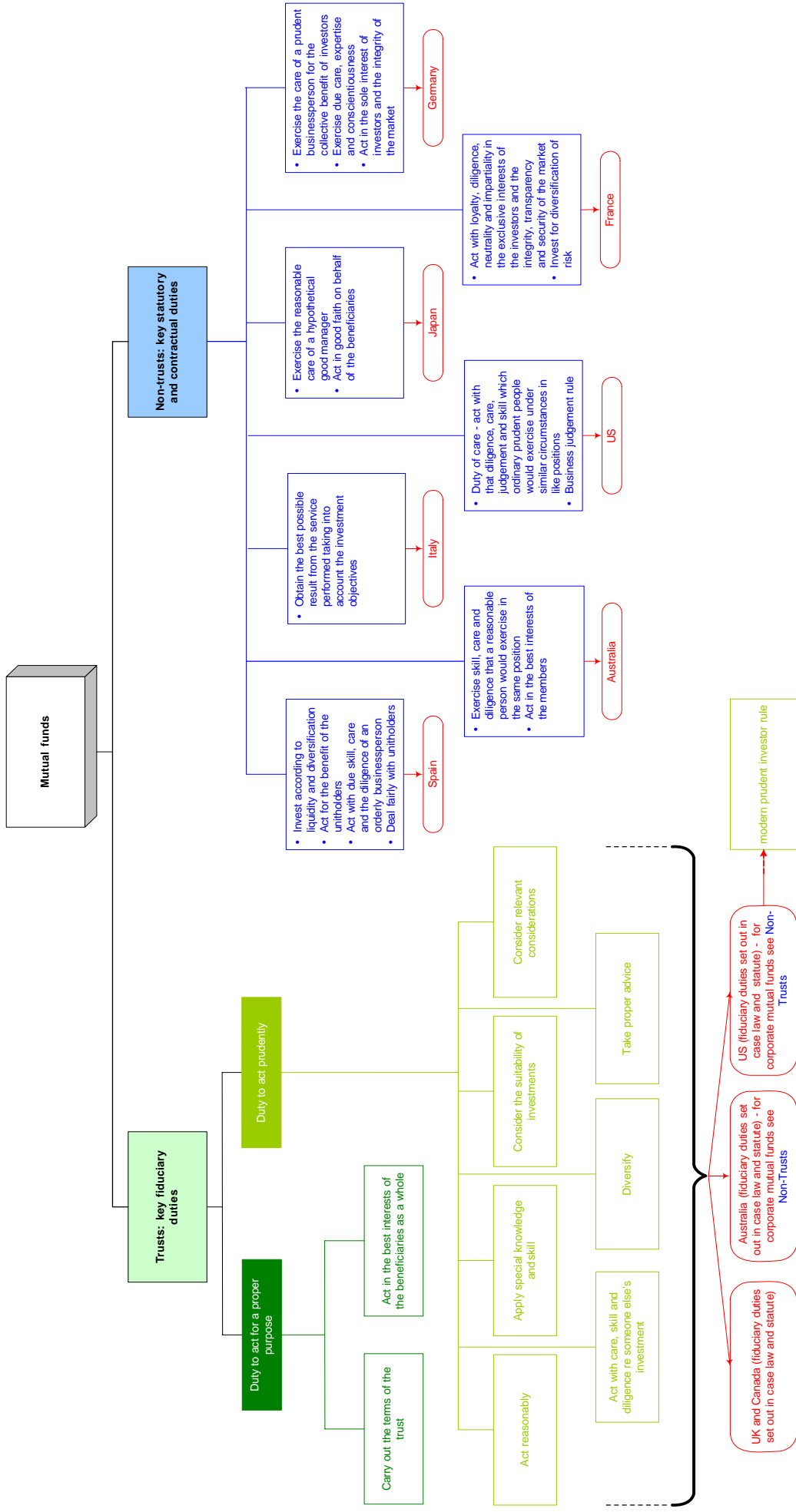
Taking ESG considerations into account



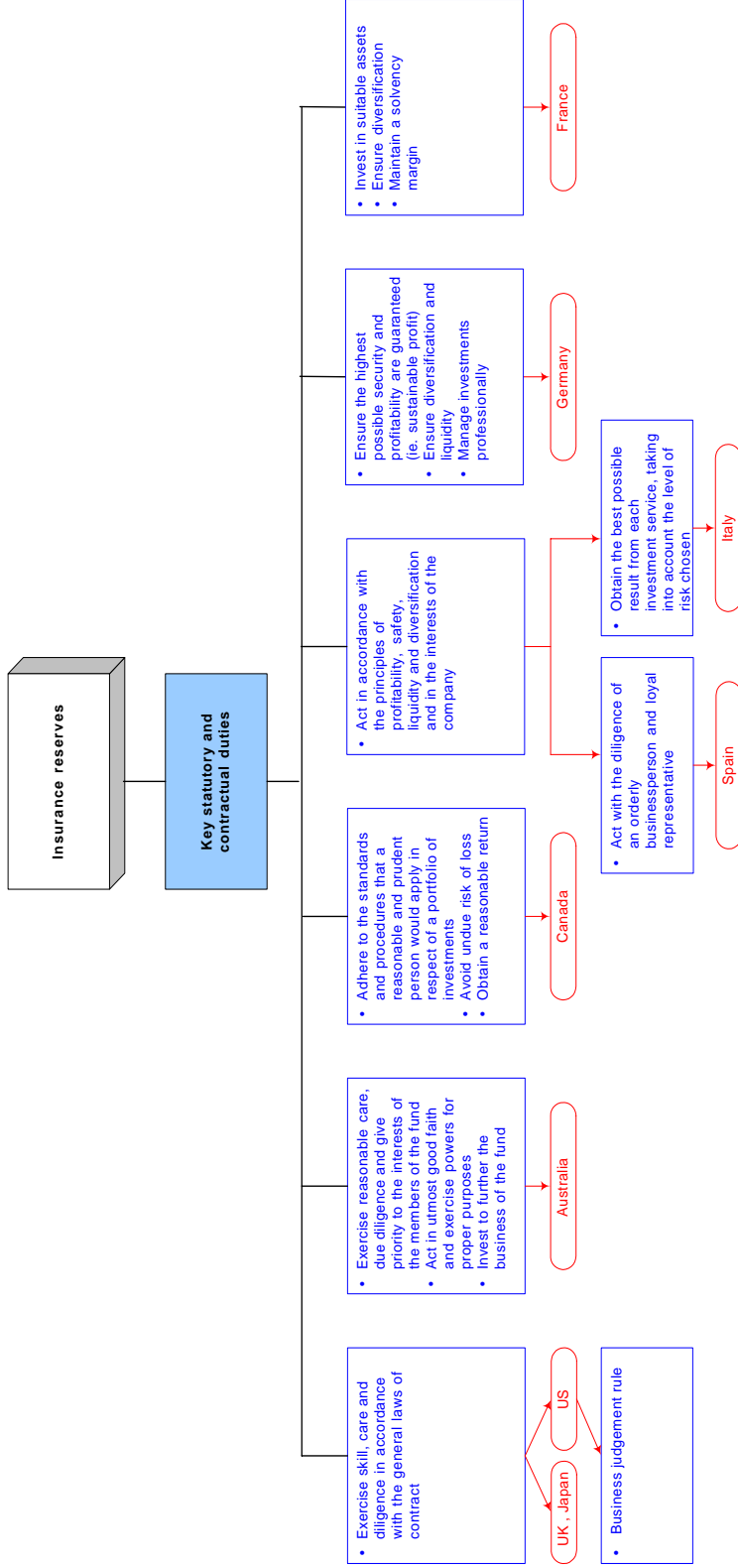
Duties diagram I: Pensions



Duties diagram II: Mutual funds



Duties diagram III : Insurance reserves



Definitions

BENEFICIARIES

It is not possible to define exhaustively the classes of persons who will constitute beneficiaries under each of the types of fund in the various jurisdictions examined in this report. Where a trust is involved, as is often the case in the common law jurisdictions, the specific legal definition of beneficiary is ‘the person for whose benefit property is held in trust’. In this report, however, the term is used more broadly and is intended also to denote those who stand to receive a benefit under a fund even where no trust is involved.

The range of possible beneficiaries may be wide. In the UK, the pensions regulator has issued guidance that states that beneficiaries of occupational pension schemes may include:

- active members - employees who are building up benefits in the scheme;
- pensioner members - people who are receiving a pension from the scheme;
- deferred members - people who have left the scheme, but who still have benefits in it (for example, because they have not transferred all their benefits to another pension arrangement);
- prospective members - people who, if they go on to meet the eligibility conditions, may be entitled to join the scheme at a future date;
- widows and widowers of members;
- dependants of members - for example, their children or other relatives who financially depend on them;
- former husbands and wives of members who, as a result of a pension-sharing order on divorce, have been granted pension credits within the scheme; and
- in some circumstances the employer who, for example, may be able to receive a payment from the scheme if there is a funding surplus when the scheme is wound up.

ESG INVESTMENT

In this report, ‘ESG investment’ is intended to refer broadly to investment decision-making that takes account of environmental, social and governance¹⁴ considerations.

The Enhanced Analytics Initiative¹⁵ defines environmental, social and governance issues as having one or more of the following characteristics:

- are the focus of public concern (eg genetically modified organisms);
- are qualitative and not readily quantifiable in monetary terms (eg corporate governance, intellectual capital);
- reflect externalities not well captured by market mechanisms (eg environmental pollution);
- are often the focus of a tightening policy and regulatory framework (eg greenhouse gas emissions); or
- arise throughout the company’s supply chain (eg labour issues at supplier factories).

¹⁴ The OECD defines corporate governance as ‘dealing with the rights and responsibilities of a company’s management, its board, shareholders and various stakeholders. OECD Steering Group on Corporate Governance, *Frequently Asked Questions* (www.oecd.org/faq)

¹⁵ For further information, see www.enhanced-analytics.com.

FIDUCIARY DUTIES

Fiduciary duties are duties that common law jurisdictions impose upon a person who undertakes to exercise some discretionary power in the interests of another person in circumstances that give rise to a relationship of trust and confidence. The circumstances in which fiduciary duties will apply are not fixed because they are a product of case law rather than statute, but courts in the common law jurisdictions discussed in this report have all held that a principal exercising the role of ‘trustee’ will owe fiduciary duties to beneficiaries under the trust.

Of the various fiduciary duties that have been articulated by the courts, only those that govern how trustees may exercise powers of investment are dealt with. It should be noted that the investment decision-makers the subject of this report may be under a range of other fiduciary duties (such as duties to avoid conflicts of interest) and, since the circumstances giving rise to fiduciary duties are not fixed, future courts may extend the range and scope of the duties and the circumstances in which they apply.

Not every breach of duty by a person occupying a fiduciary role will amount to a breach of fiduciary duty: ‘simple carelessness’ by a solicitor in giving advice to his client has been held not to be a breach of the duty to act in the interests of the client because it constituted incompetence rather than disloyalty.¹⁶

INSTITUTIONAL INVESTMENT FUNDS

The report examines the legal duties applicable to the following types of fund:

- public and private pensions;
- mutual funds; and
- insurance company reserves.

For convenience, we refer to these funds collectively as ‘institutional investment’ funds. There are other forms of institutional investment, such as invested state social security reserves, which this report does not address.

INVESTMENT DECISIONS

‘Investment decisions’ is a collective term for the activities associated with the selection, retention and realisation of investments and extends to the provision and receipt of investment advice. It includes decisions associated with ‘engagement’, the process by which investor shareholders seek to influence the management of the companies in which they invest via the use of voting rights and other less direct means. Decisions as to whether and how to participate in engagement should be informed by the same duties that govern decisions about whether to purchase, retain or sell an investment, in that both activities must be driven by the interests of the beneficiaries and must be the result of a proper decision-making process. Where differences exist between the jurisdictions with respect to engagement, these are dealt with in the sections of the report dealing with each jurisdiction.

INVESTMENT DECISION-MAKERS

We use the term ‘investment decision-makers’ to refer to the participants in the investment chain who most directly influence institutional investment management, both at a higher strategic level and at a day-to-day management level, namely:

- principals/institutional asset owners (often ‘trustees’ in jurisdictions that recognise a trust structure);
- investment consultants; and
- asset or fund managers.

¹⁶ *Bristol & West Building Society v Mothew* [1998] 1 Ch 18.

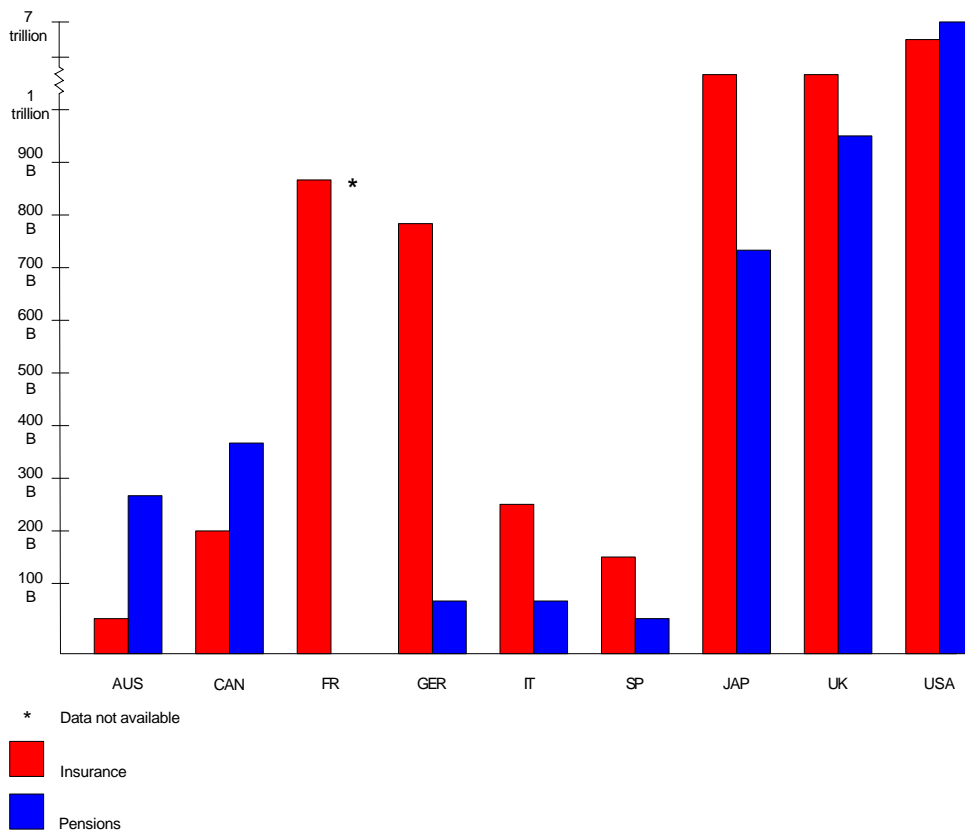
Institutional investment: an overview

1 THE GLOBAL INSTITUTIONAL INVESTMENT MARKET

The worldwide investment industry is substantial: the current value of invested funds is estimated to be over US\$42 trillion.¹⁷ Of this figure, the US investment industry accounts for around 53 per cent, Europe 33 per cent and Asia 10 per cent.

Breaking this worldwide figure down further: in the UK in 2002 the total value of investment assets was over US\$2 trillion; in the US over US\$19 trillion; in Japan over US\$3.6 trillion; in Canada and Australia over US\$1.4 trillion and in France, Germany, Spain and Italy over US\$4.5 trillion.¹⁸ However, the investment funds that accounted for the largest proportion of this US\$42 trillion belonged to institutional investors. The table below shows the value (as at 2002) of insurance and pension investment in these countries.¹⁹

Table 1: Total value of insurance and pension investment assets by country



¹⁷ For further information see www.ifsl.org.uk.

¹⁸ For further information see <http://cs4hq.oecd.org/oecd/eng/TableViewer/Wdsview/dispviewp.asp?ReportId=1880&bReportOnly=True>; and www.oecd.org.

¹⁹ Unless specified otherwise the amounts are in billions of US dollars.

2 INVESTMENT SPREAD

Historically, institutional investors invested largely in equity and debt securities (both individual shares and bonds and collective investments such as mutual funds). More recently, investments have diversified into real estate, hedge funds, private equity and other alternative investments.²⁰

As a result, and given the financial size of the portfolios held by institutional investors, it is clear that the investment decisions made by such investors have considerable impact on the environment and on society as a whole. The question is therefore to what extent can those investment decisions take account of environmental, social and governance issues?

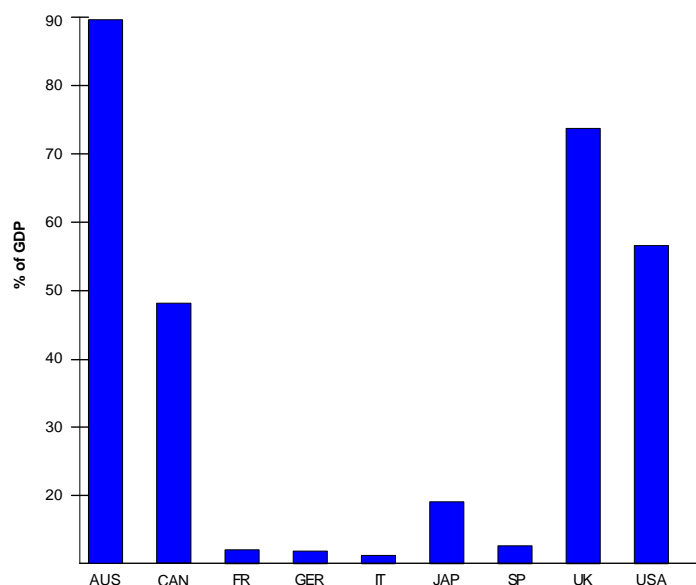
3 TYPES OF INSTITUTIONAL INVESTORS

As this study focuses on pensions funds, insurance companies and mutual funds, we outline below the main characteristics of each type of investor.

Pension funds

Occupational pension funds are pre-funded by employer and/or employee contributions and those contributions are managed/invested by trustees or managers (or agents on their behalf) to produce a return anticipated to provide a pension for employees or their survivors on retirement or death. Pension funds are usually set up under some form of trust arrangement where the trustees controls the fund's assets and are responsible for its administration and operation. The trustees have legal title to the fund's assets and consequently have power over those assets. Trustees are under a duty to hold the assets for the benefit of the pension fund members, who have rights that can be enforced against the trustees.²¹ In addition, the specific duties imposed on trustees are set out in statute, in the relevant trust documents, in the rules of the particular pension scheme or in principles of common law in the respective jurisdiction. Although trustees bear legal responsibility for controlling the assets of the trusts, trustees will often delegate aspects of investment decision-making to professional fund managers. The relationship between trustees and fund managers is generally governed by an investment management agreement.

Table 2: Pension assets as a percentage of GDP (2002)



For Germany, only Pensionkassen (company pension schemes operated by insurance companies) are included. For Japan, Spain and UK 2001 figures have been provided

Source: OECD Global Pensions Statistics Project, 2005 and IMF Working Paper, Pension Funds and Emerging Markets, 2004

For Australia 2005 figures have been provided Source: ABS and APRA

²⁰ In June 2004, the pension and investment press reported that, globally, the largest US asset management firms managed US\$563bn in hedge funds, real estate, private equity, venture capital, structured finance and a variety of hybrid instruments, a significant increase on previous years (Christine Williamson, *Explosion: Big Old-Line Firms Flock to Alternatives*, Pensions & Investments, October 2004).

As well as employer/employee funded pension schemes, there are also private individual pension plans. These pension plans are generally available to individuals who are not eligible to join an employer's pension fund or who wish to make extra contributions.²²

Table 2 above sets out pension assets as a percentage of gross domestic product (GDP) for the jurisdictions covered by this report.

There are two general approaches to investment management.²³

<p>APPROACH 1 The balanced mandate or managed fund</p>	<p>(1) Trustees entrust the assets of the fund to a fund management company (possibly more than one), leaving both strategic asset allocation and security selection to them.</p> <p>(2) Manager performance is measured with reference to certain objectives defined in advance.</p>
<p>APPROACH 2 The customised benchmark model</p>	<p>(1) This model separates out decisions about strategic asset allocation from decisions about security selection. Instead of entrusting all their funds to a single manager with a peer group benchmark, trustees use a specialist mandate and customised benchmark.</p> <p>(2) Specific instructions are given to each manager to invest in one asset class only, usually with the relevant index as a benchmark, or a mandate is given to invest in more than one asset class but with a combined benchmark, which effectively sets out parameters for the fund manager's asset allocation.</p> <p>(3) The stock selection decision remains with the manager, and the strategic asset allocation decision rests with the trustees.</p>

Globally, although pension funds hold a substantial stake in equity and debt markets and are generally invested across the entire market, they are also invested in a variety of other instruments. Therefore, pension funds own a large percentage of the world's total capital market and as a result have significant interest both in the financial performance and in the general behaviour of the companies in which they are invested,²⁴ and, to a varying extent, in the behaviour of the economy as a whole.

Mutual funds

When an individual or a company invests capital in a mutual fund, this capital is pooled with all other monies received from individuals or companies. This pool of money is then invested by fund managers, who will choose various financial products they believe will help achieve the fund's financial objectives.²⁵ In return for this investment, the investor receives shares in the mutual fund and becomes a shareholder. Mutual funds are generally open-end investment companies that buy back or redeem their shares at current net asset value. Most mutual funds continuously offer new shares to accommodate new investors. At the end of 2004 the global value of mutual fund assets was US\$16.06 trillion, an increase of 14.3 per cent on the previous year.²⁶

²¹ *Basic Guide to Pensions 2001*, Tolleys.

²² For further information see <http://sharingpensions.co.uk>.

²³ Paul Myners, *Institutional Investment in the United Kingdom: A Review*, London HM Treasury, 2001.

²⁴ Gil Yaron, *Acting Like Owners: Proxy Voting, Corporate Engagement and the Fiduciary Risk of Pension Trustees*, 14 October 2004.

²⁵ For further information, see www.citibank.com/ipb-singapore/mutual.htm.

²⁶ For further information, see www.ici.org/stats/mf/arcglo/ww_12_04.html#TopOfPage.

Insurance reserves

To generate profit, insurers invest the premium they receive from individuals and organisations seeking to protect themselves against risk. Given the magnitude of insurance reserves held by insurance companies, they rank among the most powerful institutional investors globally. For example, in Canada life and health insurance companies hold domestic assets of C\$250bn, which ranks third among the country's financial industries, behind banks (C\$1,023bn) and mutual funds (C\$290bn).²⁷ In 1999, UK insurers had £1.1 trillion of assets. The life insurance business accounted for £977bn of this.²⁸

The sheer size of funds invested globally by institutional investors, such as pension and insurance companies, gives these institutional investors significant power over the companies in which they invest. As a result, they are able to influence how these companies are managed and how they operate in general. For example, in the UK insurance companies own almost a quarter of the total shares in issue on the London Stock Exchange. Therefore, the Association of British Insurers (ABI),²⁹ the body that represents insurance companies in the UK, is able to issue corporate governance guidelines³⁰ that it believes listed companies should follow. The ABI guidelines influence, among other things, the method by which a company can increase its share capital.

Similarly, the Pension Investment Association of Canada³¹ uses its considerable influence to promote standard investment practices with regard to pension assets, evaluate federal and provincial law and regulation and develop, monitor and promote corporate governance in Canada as a whole.

4 ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES IN INVESTMENT DECISION-MAKING

As public awareness of the environmental and social impacts of corporate activity has grown, the attitude of capital markets to ESG investment appears also to have evolved. As a result, investment with regard to ESG performance is becoming increasingly mainstream.

A 2005 survey of 195 fund managers from around the world by Mercer Investment Consulting revealed that the use of positive screening for environmental, social and ethical factors is entering mainstream investment analysis particularly where such screening may potentially yield superior financial performance by targeting companies that adopt socially responsible practices and thereby avoid future liabilities and losses. The study revealed that 70 per cent of fund managers believe the integration of environmental, social and ethical factors into investment analysis will become a mainstream part of investment management within three to 10 years; 5 per cent predict this outcome within one to two years. The greatest support for taking environmental, social and ethical factors into account is shown in Europe; the least in the US. Moreover, 50 per cent believe active ownership will be mainstream within the next two years and 60 per cent believe screening for environmental, social and ethical factors will be mainstream within the next three to 10 years.³²

²⁷ Figures taken from www.fin.gc.ca, the website of the Department of Finance, Canada, *Canada's Life and Health Insurers, Fact Sheet*, updated as at 3/11/04.

²⁸ Paul Myners, *op. cit.*, page 32.

²⁹ For further information, see <http://www.abi.org.uk>.

³⁰ For further information, see <http://www.ivis.co.uk/pages/guidelines>.

³¹ For further information, see <http://www.piacweb.org>.

³² Jane Ambachtsheer, *Socially Responsible Investing – Moving into the Mainstream*, 23 June 2005 (www.merceric.com).

Commentary suggests that this movement toward mainstream consideration of ESG issues in investment decision-making is a response to a variety of different factors, including the following.

- Increasing evidence of the nexus between performance on ESG issues and financial performance³³
- Stakeholder activism
- Reputational concerns³⁴
- Consumer pressure/public opinion³⁵
- Pressure from research bodies,³⁶ investor initiatives and non-governmental organisations (NGOs)
- Pressure from the insurance industry³⁷
- Introduction of corporate environmental reporting obligations
- The rise of the global company³⁸
- Adoption of investment guidelines by the World Bank, IFC and other intergovernmental lenders
- Growing corporate transparency
- The information technology revolution³⁹
- Regulation mandating disclosure of ESG investment policies

No doubt in response to a combination of a number of the above factors, institutional investors have increasingly chosen to interrogate the way companies operate, ‘confronting the dual aspect of value and values with respect to their investments’.⁴⁰ This process of understanding and reacting to ESG performance is generally undertaken in two key ways: screening investments and shareholder activism.⁴¹

³³ *Opinion: Climate for Ethical Investment Hots Up*, Financial Times, 17 May 2004. Note the research work of the recently established Generation Foundation. In part, the objective of the Foundation is to support research into how factors of social and environmental performance affect both corporations and communities, and to explore how such factors may be reflected in firm share value.

³⁴ Charles J Fombrun, *Reputation: Realizing value from corporate image*, Harvard Business School Press, cited in *Socially Responsible Investment and International Development: A Guide for Trustees and Fund Managers*, Just Pensions, May 2001. Fombrun put a figure of \$52bn on the reputational capital of Coca-Cola, \$12bn for Gillette and \$11bn for Eastman Kodak.

³⁵ *Socially Responsible Investment and International Development: A Guide for Trustees and Fund Managers*, Just Pensions, May 2001: ‘Companies ignore violations of labour rights in their overseas suppliers, or do deals with unsavoury governments at their peril. They can expect public condemnation from both the media, and the increasingly sophisticated watchdogs among human rights and development organisations’.

³⁶ Institutions specialising in ESG investment research include CoreRatings, EIRIS, Innovest Strategic Value Advisors, KLD Research & Analytics, SAM Group, SiRi Company and Trucost.

³⁷ Note, for example, the recent initiatives taken by the insurance industry in relation to climate change. *A Changing Climate for Insurance*, Association of British Insurers, June 2004, analyses the practical implications of climate change for the insurance sector, and identifies the need for action by insurers and governments to manage climate change; note also the recently published report *Climate change and the financial sector: an agenda for action*, WWF-Allianz, June 2005.

³⁸ *Socially Responsible Investment and International Development: A Guide for Trustees and Fund Managers*, Just Pensions, May 2001: ‘[T]he vulnerability of people living in extreme poverty and the problems of operating in an impoverished environment have drawn increasing public attention.’

³⁹ This ‘revolution’ is said to have encouraged the ‘democratisation of finance’ – see , *Industry as a partner for sustainable development- Finance and Insurance*, UNEP’s Finance Industry Initiatives, 2002.

⁴⁰ Gil Yaron, *Fiduciary Duties, Investment Screening and Economically Targeted Investing: A Flexible Approach for Changing Times*, 17 May 2005, p. 3.

⁴¹ Note ESG Investment is not confined to these two areas, and may also include community economic development, social venture capital and economically targeted investing. See Gil Yaron, *ibid*.

Screening investments

Screening of investments is one method of incorporating ESG considerations into the investment decision-making process, applying ESG ‘screens’ to the choice of investments. The three basic types of screening that we understand are typically used by modern day investment practitioners are as follows.⁴²

Passive screening	Passive screening involves making investment decisions by following indices with ESG benchmarks, such as the Dow Jones Sustainability Index, the Dow Jones Islamic Market Index, FTSE4 Good and KLD’s Domini 400 Social Index.
Positive screening	Positive screening sets inclusive criteria that must be met before an investment is included within a portfolio, such as strong employee relations, good corporate governance, consistent product safety, an excellent charity donation record or superior environmental performance. There are a number of different forms of positive screening, including best-in-class (selecting the companies that are ‘best’ in their industry regarding ESG considerations) and thematic investment (selecting companies that have made a commitment to responsible products or services, such as investing in renewable energy technologies).
Negative screening	Negative screening applies criteria to exclude companies on the basis of ESG performance. Negative screens may be applied to exclude, for example, organisations that manufacture alcohol, weapons, tobacco, GM foods or nuclear energy; are engaged in gaming or animal testing; have poor labour standards; or are guilty of breaching human rights.

Examples of screening

The British Post Office pension fund’s Statement of Investment Principles (SIP) states that ‘the active investment managers have been instructed by the trust... to use their best efforts to avoid investing in companies that, in the investment manager’s opinion, persistently behave without due regard for the environment or society as a whole’.⁴³

The BBC pension fund SIP states that ‘active managers have been asked to be vigilant against the effects on companies’ long term performance prospects which could arise from any practices which alienate civilised society – including socially irresponsible behaviour’.⁴⁴

The Environment Agency (UK) pension fund’s Environmental Overlay Strategy provides that the Environment Agency will ‘through monitoring their performance, ask our fund managers to explain and financially justify any investment decisions, for example our stock selection, which in its view are environmentally controversial. We will favour investing on a positive ‘best-in-class’ selection basis, and by the use of engagement, in preference to negative screening’.⁴⁵

Shareholder engagement

‘Shareholders increasingly ask questions on sourcing and ethical trading – they are realising these are issues they can no longer ignore.’

Stuart Rose, chairman of Marks & Spencer⁴⁶

Shareholder engagement or influence requires that an institutional investor understand and attempt to influence the ESG performance of an organisation through engagement with management (eg by means

⁴² For further information, see www.ssga.com. Note also that screening is undertaken not only at the time of acquiring a security but may also inform a decision to divest.

⁴³ *Response of the UK Pension Funds to the SRI Disclosure Regulation*, UKSIF, October 2000.

⁴⁴ *Response of the UK Pension Funds to the SRI Disclosure Regulation*, UKSIF, October 2000.

⁴⁵ *Active Pension Fund: Environmental Overlay Strategy*, Environment Agency.

⁴⁶ Stuart Rose of M&S, *Ethical Stance Should Be a Key Part of Sales Strategy*, Financial Times, 6 July 2005.

of dialogue, pressure and support for responsible management) and through the exercise of voting rights.⁴⁷ Just Pensions defines shareholder engagement as:

*'A conscious process in which areas of improvement are identified for individual companies. The investor then seeks to persuade these companies to commit themselves to change and then monitors the implementation of any commitments made.'*⁴⁸

Shareholder engagement with corporate management and proxy voting offer direct and visible ways in which investors can influence companies.⁴⁹

Examples of engagement

*'As responsible investors, the Lothian Pension Funds wish to promote corporate social responsibility amongst the companies in which it invests. There may be risks to shareholders in companies that do not conduct business in a socially responsible manner. Accordingly, the fund will pursue a policy of constructive shareholder engagement with companies on such issues where they are consistent with the Fund's fiduciary responsibilities, using their own efforts, their investment managers and alliances of other like-minded investors.'*⁵⁰

*'TIAA-CREF... communicate directly with companies where we perceive shortcomings in governance structure or policies. We engage in confidential discussions with board members and senior executives of the companies to explain our concerns and gain insights to their company. Our aim is to resolve privately any differences we may have. When these discussions fail to persuade us that management is responsive to shareholder interests, we may file shareholder proposals to build support for necessary change. ... To protect their long-term economic interests, shareholders have a responsibility to monitor the conduct of the board of directors and exercise their voting rights by casting thoughtful and informed proxy votes that enhance the financial interests of their investors.'*⁵¹

*'Insight affirms that investors have both a moral responsibility and a compelling long-term interest in providing support and encouragement to companies in their efforts to achieve the standards set by global business principles. We propose that investors should also play a full part in holding companies accountable for compliance with these principles. The increasing ability and willingness of investors to play these roles, coupled with their global reach, means that there is now a genuine opportunity for investors to make a worthwhile contribution in this area.'*⁵²

*'At F&C, being an active shareholder means entering into constructive dialogue with companies to understand and discuss how they can better manage their impacts on the environment and society, to explore the business case for doing so and to exercise our voting rights fully and responsibly. We believe that through such engagement we can enhance the management of SEE risks by companies, and thereby protect the value of our shareholdings.'*⁵³

⁴⁷ Funds such as Universities Superannuation Scheme in the UK (USS) occasionally invest in companies with a relatively poor ESG record with the view to enforcing a positive change in their performance. Interview with David Russell of USS.

⁴⁸ Socially Responsible Investment and International Development: A Guide for Trustees and Fund Managers/Just Pensions, May 2001.

⁴⁹ Engagement can also include referral of shareholder resolutions to the trustees for exercise of their voting discretion. The UK Environment Agency (EA) pension fund found that following their decision to take a proactive role in voting on shareholder resolutions, in excess of 20 resolutions related to environmental issues were referred to them by their new fund managers in 2005 and resulted in a different vote being made from that of the fund manager. From an interview conducted with Howard Pearce, Head of Environmental Finance and Pension Management Fund, EA, by Freshfields Bruckhaus Deringer on 11 July 2005.

⁵⁰ Extract from the Lothian Pension Funds SIP, April 2001: *Socially Responsible Investment and International Development: A Guide for Trustees and Fund Managers*, op. cit.

⁵¹ Extract from TIAA-CREF Policy Statement on Corporate Governance: Teachers Insurance and Annuity Association – College Retirement Equities Fund.

⁵² Insight Investment: www.insightinvestment.com/responsibility/project/project.asp.

⁵³ F&C Asset Management: www.fandc.com/aboutus.asp?pageID=1.3.3.

Some investors adopt an ‘integrated analysis’ approach, whereby screening and shareholder engagement are combined for maximum impact on the ESG performance of selected companies. Some commentators have suggested that engagement should be seen not as an alternative to screening but as an essential mechanism for obtaining information about corporate performance – information that may not be known to the market but that may influence investment decisions. In this way, the results of engagement feed back into and inform the investment process.⁵⁴

5 RATIONALE AGAINST AND FOR INCORPORATING ESG ISSUES INTO INVESTMENT DECISION-MAKING

It cannot be claimed that all institutional investors have embraced the move towards ESG investment. The attitude of institutional investors and their appetite for considering ESG issues as part of their decision-making process varies materially, from those who see no role for ESG issues in their decision-making to those who believe ESG issues must inform investment decisions. For some, the view that a fund must focus solely on maximising financial returns, and the absence of irrefutable evidence positively linking performance on ESG issues with financial performance, has proven a significant impediment to the development of ESG investment practices. An illustration of the range of views is set out below.

Neo-classical arguments
Any deviation from that single-minded pursuit of profit-maximisation by the admission of some other social responsibility is “fundamentally subversive”, “pure and unadulterated socialism”, something which could “thoroughly undermine the very foundations of our free society.” Businessmen subjected to “a social responsibility other than making maximum profits for stockholders” cannot know what interests to serve. ⁵⁵
ESG issues are difficult to quantify and represent investment in intangibles. The value of these intangibles is not normally captured in conventional accounting systems and therefore they ought to be excluded from investment decision-making. ‘Social investing is a precarious investment philosophy that cannot help but reflect the personal, financial, social and/or political predilections of the investor. Human nature being what it is, trustees will always be tempted to practice social investing in derogation of their fiduciary duty of undivided loyalty’. ⁵⁶
A common feature shared by all institutional investors is the short-term time scale that tends to govern their investment strategies. Accounting rules requiring pensions deficits to be accounted for in companies’ accounts, ⁵⁷ quarterly appraisals of funds managers’ performance ⁵⁸ and the highly competitive financial product market tend to limit the time frame within which institutional investors operate. Therefore, any benefits that may be derived from the long-term improvement in companies’ ESG performance will be of little application in the short or medium term. As a result, they ought not to form part of investment decision-making. <i>‘Concerning the short-term/long-term time frame, we are aware that most investors think in short to medium term. We try to adopt a long-term perspective, but are also subject to competitive pressures. For long-term investors, a short-term decline in share value (if the corporation whose shares we’re holding proposes to, say, invest in new pollution cleaning technologies) should be acceptable if the corporation can demonstrate to us that this will yield increased returns in the long-term.’⁵⁹</i>

⁵⁴ Nick Robins, *Next Stop: Market Transformation*, Accountability Forum 3(17).

⁵⁵ M Friedman, *Capitalism and Freedom* (1962) 133 and *An Economist’s Protest* (1972) 177. For a critique of this argument see e.g. C Joly, “Ethical Demands and Requirements in Investment Management” *Business Ethics: A European Review* (Vol. 2 No 4 October 1999) at 201: “The essence of business is the sustainable evolutionary adaptation of its activities to emerging opportunities and risks in its markets. Making profits means making sure the *conditions* for future profits are being put into place and this is rarely coincident with maximising short-term profits. A business builder builds an edifice for coming generations.”

⁵⁶ Professor Charles Round, Suffolk University Law School, *Fiduciary Duty, Undivided Loyalty and Socially Responsible Investment Performance*, cited in William Baue, 1 October 2004 (www.socialfunds.com)

⁵⁷ Penny Shepherd, Chief Executive of UKSIF, interviewed by Freshfields Bruckhaus Deringer on 15 July 2005.

⁵⁸ Paul Myners, *op. cit.*

‘There is a structural and intellectual roadblock in the investment management industry (at least in the US) that leads to discounting the costs of environmental issues – short-termism (also known as investment myopia). When portfolio managers are hired and paid under mandates to outperform over the following few quarters or year, they tend to ignore longer-term issues that have tremendous future costs for their fund investors, society and portfolio companies’⁶⁰

Business-case arguments

Screening of investments and shareholder activism should be exercised as long as they do not offend the principle of profit maximisation.

There is a correlation between improvement in companies’ ESG performance and their economic performance. ‘Fiduciary responsibility for the 21st century must require consideration of the social, environmental, political and cultural effects of investments, both positive and negative, over the short and long term as a fundamental part of the investment process.’ ‘This is a financial issue – one that identifies risks and opportunities not captured by conventional financial analysis’. ‘In 85% of the total number of studies assessed, we found a positive correlation between environmental governance and/or events and financial performance.’

‘For our part, Legal & General Investment Management fully embraces both the principles and practices of Socially Responsible Investment. We have a clear policy. We believe that a mature and responsible approach to social, environmental and ethical issues makes good business sense.’⁶¹

★Because institutional investors effectively own a cross-section of the economy as a whole there is a commonality between issues of significant concern to society as a whole (including ESG performance) and the fiduciary duty of the institutional investors.⁶²

Broader social arguments

The principle of the beneficiaries’ ‘best interests’ is not restricted to financial benefit. Having regard to ESG issues is about more than financial performance: it is about asking business to move away from prioritising profit over all else.⁶³

Certain investors believe that they have an obligation to act to promote adherence to international treaties and norms, particularly those that foster sustainable development and political stability. Moreover, broadly-diversified public sector funds whose beneficiaries are the taxpayer (such as le Fonds de réserve pour les retraites in France) assert that externalising the costs of poor corporate ESG performance onto other companies or to the state is not in the best interests of the fund and its beneficiaries.

Investors have a moral responsibility to support and encourage companies to achieve higher standards of corporate responsibility according to legitimate ethical principles. ‘Investors, as owners of the companies in which they invest, have a moral obligation to act to mitigate any negative social or environmental impacts of these companies.’⁶⁴

⁵⁹ Amy O’Brian and John Wilcox (TIAA-CREF), interviewed by Freshfields Bruckhaus Deringer on 26 July 2005.

⁶⁰ Comments from Keith L Johnson, Chief Legal Officer of the State of Wisconsin Investment Board, via email July 2005

⁶¹ Socially responsible investment – benefiting on issues and approaches for pooled pensions funds, Legal & General.

⁶² *Corporate Governance, Fiduciary Capitalism and Universal Owners*, St Mary’s College of California, Center for Study of Fiduciary Capitalism. ★The universal owner theory arguably should be characterised as a broader social argument as well as falling within the category of business case argument.

⁶³ Peter Kinder, KLD Research & Analytics quoted in *Moving from the Business Case for SRI and CSR to the Fiduciary Case* William Baue Feb 2004 (www.socialfunds.com).

⁶⁴ Responsible Investment Trustee Toolkit, Just Pensions 2005.

There is clearly no consensus within the institutional investment community on whether regard should be had and the weight, if any, to be given to ESG issues when making decisions on how best to invest on behalf of pension fund members and other beneficiaries. Nor is such consensus likely, taking into account the broad range of cultural and political influences on, and investment objectives of, different institutional investors. However, given the growing influence of institutional investors in determining the operation of capital markets and the significant power they wield as asset holders, it is necessary to explore the legal frameworks that govern approaches to ESG issues when making investment decisions.

1 SUSTAINABLE DEVELOPMENT – AN INTERNATIONAL LAW DUTY

Although its processes may be glacially slow on occasion, one of the peculiarities of international law⁶⁵ is that it is often in the international forum that radical new developments in legal thinking first coalesce. States seem more readily to accede to new legally binding commitments on an international plane, although the significance of those obligations in the domestic law of each State differs. Some prominent examples include the acceptance of an obligation to combat the proliferation of nuclear weapons, to accept and give shelter to foreign refugees, to surrender prestigious claims to sovereignty in Antarctica, to renounce the right to unilateral exploitation of the mineral resources of the deep seabed, etc.

One of the areas in which the international law seems to be developing is in the expansion of its scope of operations beyond the traditional “subjects” of international law (States and inter-governmental organisations like the UN or NATO) to include other actors which might have both rights and duties in international law.

This phenomenon is discernible in, among other areas, the fields of sustainable development and human rights. The international community’s attachment to what is now called sustainability dates at least from 1972, when the United Nations Conference on the Human Environment (*UNCHE*) adopted the Stockholm Declaration,⁶⁶ to which was appended a statement of principles.

These principles included a recognition that:

*‘natural resources... must be safeguarded for the benefit of present and future generations through careful planning or management...’*⁶⁷

and that

*‘[t]he capacity of the earth to produce vital renewable resources must be maintained and, wherever possible, restored or improved’*⁶⁸

while

*‘... non-renewable resources... must be employed in such a way as to guard against the danger of their future exhaustion and to ensure that the benefits from such employment are shared by all mankind’.*⁶⁹

⁶⁵ International law derives from a number of sources. The most important are treaties (sometimes called conventions, agreements, memoranda of understanding or protocols). These treaties (especially the very widely accepted ones, like the UN Charter) look like legislation, but, as States are all sovereigns and there is no international equivalent of a parliament, the true analogy in domestic law is a contract. Indeed, most treaties only bind the States which are parties to them – very few treaties have a third party effect. For some States, international treaties form an integral part of the national legal system, being in a sense ‘directly applicable’. For others, a confirmatory act by the national legislature is required. Whatever the national system, however, at the international level, adherence to a treaty creates binding legal obligations on the State towards other States party to the same treaty.

The other important source of international law is customary law. This does not derive from treaties, but from the way that civilised States behave towards one another. Custom, it might be said, is not what States say, but what they do – although it also includes what they say they do! Customary law must be consistently and uniformly accepted and applied by a State and the State must apply the custom because it feels that it is legally obliged to do so. Acceptance as custom is one of the routes by which “soft law” instruments (such as the Declarations of UN conferences, like those of Stockholm and Rio de Janeiro discussed below) can “graduate” to become binding international law norms.

⁶⁶ *Report of the UN Conference on the Human Environment*, UN doc A/CONF.48/14 at 2.65 and Corr.1 (1972)

⁶⁷ UNCHE Principle 2.

⁶⁸ UNCHE Principle 3.

⁶⁹ UNCHE Principle 5.

Although the Declaration cannot in itself form a source of international law, it contains a number of provisions that have been frequently cited by states as forming the basis for legal practice and have therefore coalesced into customary international law. Perhaps the most famous of these, UNCHE Principle 21, forms the bedrock of much of the subsequent development of international environmental law, proclaiming that the right of each state to pursue its own environmental policies is conditional upon the exercise of that sovereign right not adversely affecting the environment of other states or of areas beyond national jurisdiction.

Ten years later, the UN General Assembly adopted the World Charter for Nature,⁷⁰ which affirmed that mankind is ‘part of nature’ and that ‘life depends on the uninterrupted functioning of natural systems’,⁷¹ but which also traced a connection between respect for and protection of environmental values on the one hand and human rights and peace on the other.⁷²

Twenty years after Stockholm, the international community was wrestling with the need to integrate environmental protection with broader development goals.

The Rio Declaration on Environment and Development (*RDED*)⁷³ declares somewhat opaquely that:

*‘Human beings are at the centre of concerns for sustainable development’*⁷⁴

and introduces the right to development in the context of inter-generational equity:

*‘The right to development must be fulfilled so as to equitably meet the developmental and environmental needs of present and future generations’.*⁷⁵

In this context, the international community recognised that environmental protection and the eradication of poverty are essential elements of sustainable development,⁷⁶ as are the elimination of unsustainable patterns of production and consumption and the adoption of appropriate demographic policies.⁷⁷ The Rio Declaration is also notable for introducing the concept of ‘common but differentiated responsibilities’ for attaining sustainable development, by which developed countries acknowledge that their responsibilities reflect the pressure their lifestyles place on the environment and the technological and financial resources available to them to counteract that pressure.⁷⁸

The commitment to sustainable development also appears in the principal substantive products of the UN Conference on Environment and Development. The Framework Convention on Climate Change (*FCCC*) stresses that the UN states parties have a right to and should promote sustainable development⁷⁹ and, in particular, should protect the climate system ‘for the benefit of present and future generations’.⁸⁰ Similarly, the Convention on Biological Diversity sets out as one of its objectives the

⁷⁰ UNGA Res. 37/7 (1982), (www.un.org/documents/ga/res/37/a37r007.htm)

⁷¹ World Charter for Nature, second preambular paragraph.

⁷² ‘Competition for scarce resources creates conflicts, while the conservation of nature and natural resources contributes to justice and the maintenance of peace....’, World Charter for Nature, third preambular paragraph.

⁷³ Text available at www.unep.org/unep/rio.htm.

⁷⁴ RDED Principle 1, which continues ‘They are entitled to a healthy and productive life in harmony with nature’.

⁷⁵ RDED Principle 3.

⁷⁶ RDED Principles 4 & 5.

⁷⁷ RDED Principle 8.

⁷⁸ RDED Principle 7. The difficult concept of common but differentiated responsibilities appears again in the Framework Convention Change Convention – see Article 3(1).

⁷⁹ FCCC Article 3(4). Note that the paragraph does *not* go so far as to impose a *duty* on States to promote sustainable development, the wording being merely hortatory.

⁸⁰ FCCC Article 3(1). Note again that the extensive provisions of Article 3 merely provide *guidance* for the States Parties.

sustainable use of components of biological diversity and the fair and equitable sharing of benefits arising from these.⁸¹

Despite the frequent use of the phrase ‘sustainable development’ in international instruments, there is no universally applicable definition in any major treaty. The usual definition referred to in state practice is that crafted by the World Commission on Environment and Development (the Brundtland Commission) in 1987, namely:

*‘Development that meets the needs of the present without compromising the ability of future generations to meet their own needs’.*⁸²

It has been pointed out that this definition involves at least two important elements – the focus on needs, especially the essential needs of the present generation, and the concept of limitations on the environment’s capability to meet those needs and those of future generations.⁸³ In recent years, defining sustainable development as a potential international law norm has been complicated because some groups of states have found it necessary to develop ‘case-specific’ definitions, owing to the inchoate nature of the Brundtland version. An example can be found in the Convention for the Protection and Sustainable Development of the Marine and Coastal Environment of the North-East Pacific:⁸⁴

*‘For the purposes of this Convention, sustainable development means the process of progressive change in the quality of life of human beings, which places it as the central and primordial subject of development, by means of economic growth and social equity and the transformation of methods of production and consumption patterns, and which is sustained in the ecological balance and vital support of the region. The process implies respect for national, regional and local ethnic and cultural diversity, and full participation of people in peaceful coexistence and harmony with nature, without prejudice to and ensuring the quality of life of future generations.’*⁸⁵

This comprehensive definition is too developed to be presented as a generally applicable rule of international law,⁸⁶ but it is interesting that it makes a direct connection between sustainable development and other human rights norms, which undoubtedly do form part of the general international law.

2 HUMAN AND COMMUNITY RIGHTS

The classic function of human rights law, as envisaged in the post-war period, was to protect individuals against abuse by their own (or sometimes other) state entities⁸⁷. In the intervening period,

⁸¹ FCCC Articles 1 & 6. The latter article, at least, does contain mandatory duties in relation to sustainable use.

⁸² *Our Common Future*, the Report of the World Commission for Environment and Development, OUP 1987, at p.43.

⁸³ Sands, *Principles of International Environmental Law*, (2nd.Edition), Cambridge 2003, at pp.10-11, 252-3. Note that the Convention on Biological Diversity contains a definition of ‘sustainable use’ of components of biological specifically, namely that such use ‘does not lead to the long-term decline of biological diversity, thereby maintaining its potential to meet the needs *and aspirations* of present and future generations’ – Article 2 (emphasis added).

⁸⁴ Antigua, 18th February 2002. (www.cep.unep.org/services/nepregseas/nepregseas.htm)

⁸⁵ Article 3(1)(a).

⁸⁶ It is of course binding on the States party to the Antigua Convention.

⁸⁷ The protection in international law of the fundamental rights of individuals is largely a product of the post-World War II reorientation of international relations. This development of human rights protection stems from the UN Charter itself, which includes among the purposes of the UN: ‘...*promoting and encouraging respect for human rights and for fundamental freedoms for all without distinction as to race, sex, language or religion...*’. (Article 1(3)). Whereas the basic guarantees for specific rights of the individual are contained in the Charter and the Universal Declaration of Human Rights, substantive international legal protection has come largely from two further sources:

- the widely accepted International Covenants on Civil and Political Rights and on Economic, Social and Cultural Rights; and

however, it has become clear that many important threats to the rights of the vulnerable come, not from states, but from non-state entities, ranging from Al Qaeda to multinational corporations. In that period, also, the former exclusivity that limited the subjects of public international to sovereign states and international organisations has been substantially eroded to permit individuals some standing in the discipline, a development in which human rights law played an important role.⁸⁸

A consequence of this change in focus is the question of whether human rights obligations are horizontal as well as vertical ie whether they are owed not only by states but also by non-state entities. This remains a controversial and developing field, but a number of attempts have recently been made to fix multinational corporations with an international legal obligation to respect human rights.

Following the failure of attempts to negotiate a Multilateral Investment Agreement, a range of international organisations have undertaken initiatives in this regard. Prominent among these are the UN Global Compact and the OECD Guidelines for Multinational Enterprises.

The UN Global Compact is a voluntary initiative in which the UN seeks to engage corporations to observe a set of minimum standards in the fields of worker protection, human rights, anti-corruption and environmental protection.

Broadly, these standards address:

- respect for human rights as set out in the major international instruments;
- avoidance of complicity in human rights abuses;
- freedom of employees to associate and engage in collective bargaining;
- elimination of forced labour and child labour;
- non-discrimination;
- a precautionary approach to environmental harm;
- promotion of environmental responsibility;
- developing and spreading of environmentally sound technology; and
- avoidance of corrupt practices.

The OECD Guidelines cover similar ground, with the addition of specific obligations on the protection of consumer interests, technology transfer, anti-competitive behaviour and disclosure of corporate information (including governance structures and policies, risk factors affecting the company's activities and perhaps social, ethical and environmental policies).

An intermediate position is reflected in the UN Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights, developed under the auspices of the Sub-Commission on the Promotion and Protection of Human Rights. This document stresses the classical view that the primary duty to ensure that corporations respect human rights lies upon states⁸⁹ but it goes on to assert that:

'Within their respective spheres of activity and influence, transnational corporations and other business enterprises have the obligation to promote, secure the fulfilment of, respect, ensure respect of and protect human

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- a group of regional human rights treaties of varying degrees that provide or aim to provide a robust and effective system for monitoring and implementing state obligations, including individual access to an enforcement mechanism in case of abuse: see the European Convention on Human Rights, the Inter-American Commission on Human Rights and the African Charter on Human and Peoples' Rights.

⁸⁸ Along with the regime of international protection for foreign investment.

⁸⁹ Paragraph 1 – 'States have the primary responsibility to promote, secure the fulfilment of, respect, ensure respect of and protect human rights recognized in international as well as national law, including ensuring that transnational corporations and other business enterprises respect human rights.'

rights recognized in international as well as national law, including the rights and interests of indigenous peoples and other vulnerable groups.⁹⁰

In addition to the specific obligations on corporations of the type contained in the Global Compact or the OECD Guidelines, the Norms contain more far-reaching duties, including a requirement that:

*‘Transnational corporations and other business enterprises shall respect economic, social and cultural rights as well as civil and political rights and contribute to their realization, in particular the rights to development, adequate food and drinking water, the highest attainable standard of physical and mental health, adequate housing, privacy, education, freedom of thought, conscience, and religion and freedom of opinion and expression, and shall refrain from actions which obstruct or impede the realization of those rights.*⁹¹

and that:

*‘As an initial step towards implementing these Norms, each transnational corporation or other business enterprise shall adopt, disseminate and implement internal rules of operation in compliance with the Norms. Further, they shall periodically report on and take other measures fully to implement the Norms and to provide at least for the prompt implementation of the protections set forth in the Norms. Each transnational corporation or other business enterprise shall apply and incorporate these Norms in their contracts or other arrangements and dealings with contractors, subcontractors, suppliers, licensees, distributors, or natural or other legal persons that enter into any agreement with the transnational corporation or business enterprise in order to ensure respect for and implementation of the Norms.*⁹²

None of these instruments, however, can be said to create generally applicable international law obligations, but there is some evidence of the international law imposing such obligations on non-state entities. The Universal Declaration on Human Rights, for example, imposes the duty to promote human rights on ‘every individual and organ of society’⁹³ and recognises that:

‘Everyone has duties to the community in which alone the free and full development of his personality is possible.’⁹⁴

This approach is developed further in the African Charter of Human and Peoples’ Rights, which contains a series of articles providing that individuals have duties to each other and to other persons, including the international community, and that this duty is owed on a non-discriminatory basis for the purpose of promoting mutual respect and tolerance.⁹⁵ In the field of sustainable development, there is an echo of the same approach in the Charter for Nature:

‘Each person has a duty to act in accordance with the provisions of the present Charter...’⁹⁶

There is, therefore, some evidence of a developing principle of international law that enjoins respect for environmental and other human rights values upon non-state entities.

3 MEETING THE CHALLENGE

Even if it is true that the international law is inching towards the acceptance of binding obligations on non-State actors, little practical benefit will accrue unless those actors are given some indication as to what is expected of them.

⁹⁰ Ibid.

⁹¹ Paragraph 12.

⁹² Paragraph 15.

⁹³ Universal Declaration on Human Rights, preamble.

⁹⁴ Ibid, Article 29(1). See also Article 30 which denies the right of ‘any State, group or person ..to engage in any activity or perform any act aimed at the destruction of any of the rights and freedoms’ referred to in the Declaration.

⁹⁵ See generally African Charter on Human and Peoples’ Rights, Articles 27-29.

⁹⁶ Paragraph 24.

In this connection, the lead is being taken by international organisations, often in partnership with elements of the commercial community, seeking to translate into practical terms the somewhat inchoate demands of the developing international law. This phenomenon even has an institutional aspect, of which the UNEP FI is an illustration, being a joint programme between the UN body with responsibility for the system-wide environmental response and a burgeoning group of major commercial and financial institutions.

In substantive terms, UNEP FI has begun to tackle the thorny task of interpreting for the business community what is now expected of it in terms of social, ethical and environmental performance. Two illustrations highlight this role.

The first is the ongoing project to develop a vade mecum for the implementation of responsible investment, firstly by devising in the current calendar year a set of principles to guide the financial community in structuring its investment patterns so as to comply with the expectations of the developing international legal regime. This is then to be complemented and reinforced by a further programme aimed at capacity-building (another traditional UNEP function) in both the financial sector itself and also in the regulatory community with which it interacts.

The second illustration lies in the continuing work undertaken in collaboration with the Global Reporting Initiative to develop supplements to the 2002 Sustainability Reporting Guidelines which address the social and environmental performance of the financial services sector.

These developments go beyond the familiar “soft-law” processes familiar in other spheres, in that, rather than merely expressing aspirations on the part of the increasingly diverse international community, they have the effect of conferring specificity on international norms as they are formulated.

1 INTRODUCTION

The European jurisdictions covered by this report⁹⁷ are members of the European Union (EU), and as such are subject to the legal regime and decisions of the EU institutions. The extent to which these institutions have considered and incorporated initiatives aimed at encouraging ESG investment into policy at the EU level will, therefore, inform the work of individual EU member states.

The integration of ESG considerations into investment decision-making has been discussed within the broader context of sustainable development⁹⁸ and, in particular, CSR. The European Commission regards SRI as an important tool in encouraging CSR.⁹⁹

2 KEY PAN-EU INITIATIVES ON SRI¹⁰⁰

Fifth Environmental Action Programme

In February 1993, the Council and the representatives of the governments of the member states approved a resolution on a Community programme of policy and action on the environment and sustainable development.¹⁰¹ Better known as the Fifth Environmental Action Programme, it set long-term objectives and initiated a global approach to sustainability issues. In an early recognition of the power of financial institutions in achieving sustainability, the programme stated that:

‘Financial institutions which assume the risk of companies and plants can exercise considerable influence – in some cases, control – over investment and management decisions which could be brought into play to the benefit of the environment.’¹⁰²

The Commission’s subsequent Green Paper on CSR echoed the important role of financial institutions in CSR.

The Commission Green Paper on promoting CSR¹⁰³

Recognising that CSR can make a positive contribution to the strategic goal of Europe becoming ‘the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion’¹⁰⁴, the Commission issued its Green Paper on CSR. The Commission’s aim was to launch a wide debate on how the EU could promote CSR at both the European and the international level, in particular on how to make the most of existing experiences, to encourage the development of innovative practices, to create greater transparency and to increase the reliability of evaluation and validation.

⁹⁷ France, Germany, Italy, Spain and the UK.

⁹⁸ See for example *A Sustainable Europe for a Better World: A European Union Strategy for Sustainable Development* COM(2001) 264

⁹⁹ Whilst this report refers to ESG investment, the work done by the European Commission uses the narrower term SRI – socially responsible investment.

¹⁰⁰ Tables setting out legislation and legislative initiatives in Member States not addressed in detail in this report are attached at Appendix J.

¹⁰¹ *Towards Sustainability*, Official Journal C 138, 17/05/1993, p.1, the European Community Programme of policy and action in relation to the environment and sustainable development (better known as The Fifth EC Environmental Action Programme).

¹⁰² Ibid. at paragraph 3.2

¹⁰³ *The Commission Green Paper on promoting a European framework for Corporate Social Responsibility* COM(2001) 366 final (18/07/2001).

¹⁰⁴ The Lisbon Strategy, for further information, please see WAP: //europa.eu.int/growthandjobs/index.en.htm.

The Green Paper identified four factors as the driving forces in the move towards CSR:

- new concerns and expectations from citizens, consumers, public authorities and investors in the context of globalisation and large scale industrial change;
- social criteria increasingly influencing the investment decisions of individuals and institutions both as consumers and as investors;
- increased concern about the damage caused by economic activity to the environment; and
- transparency of business activities brought about by the media and modern information and communication technology.

It suggested an approach ‘based on the deepening of partnerships in which all actors have an active role to play’. In relation to financial institutions, the Green Paper stated that:

‘Financial institutions can play a particular role through community investing, which consists of direct investments in projects benefiting specific communities or constituencies, especially in economically disadvantaged areas. These investments usually take the form of loans for low-cost housing ventures or deposits in community development banks either at or below market rates.’

The Green Paper noted the increasing popularity of SRI, stating that:

‘In recent years, socially responsible investing (SRI) has experienced a strong surge in popularity among mainstream investors. Socially and environmentally responsible policies provide investors with a good indication of sound internal and external management. They contribute to minimising risks by anticipating and preventing crises that can affect reputation and cause dramatic drops in share prices.’

However, it was acknowledged that there was a lack of harmonisation and transparency in screening and monitoring techniques, which was hindering the uptake of CSR. The Commission emphasised that due to ‘many specialised screening agencies (non-financial analysts) using a number of different tools and metrics... there is... a need for more convergence between indicators developed by companies and the criteria used by analysts to assess a company’s social and environmental performance. Furthermore, the lack of transparency in evaluation methods used by screening agencies may also restrain large investors from making significant socially responsible investments. There is, therefore, a need for further standardisation, harmonisation and transparency in screening tools and metrics used by screening agencies.’¹⁰⁵

The Commission concluded that ‘for SRI to contribute to the promotion of CSR, the development by rating organisations¹⁰⁶ – independent consultants or SRI departments of investment banks – of criteria and indicators which identify the factors of competitive advantage and business success of socially responsible enterprises is essential’.¹⁰⁷

The Commission Communication Concerning Corporate Social Responsibility¹⁰⁸

In its 2002 Communication on CSR, the Commission again articulated the ‘growing perception among enterprises that sustainable business success and shareholder value cannot be achieved solely through maximising short-term profits, but instead through market-oriented yet responsible behaviour’¹⁰⁹. The Communication included the following important initiatives:

- that occupational pension schemes and retail investment funds disclose whether and how they take account of social, environmental and ethical factors in their investment decisions;
- that initiatives aiming at monitoring and benchmarking practices of pension funds and investment funds with regard to and in support of CSR be encouraged; and

¹⁰⁵ *Commission Green Paper*, para 88.

¹⁰⁶ This point is made by Howard Pearce, Head of Environmental Finance and Pension Management Fund, Environment Agency, 11 July 2005.

¹⁰⁷ *Commission Green Paper*, p.16

¹⁰⁸ *The Commission Communication concerning Corporate Social Responsibility: A Business Contribution to Sustainable Development* COM(2002) 347 final (02/07/2002).

¹⁰⁹ *Ibid.* p.5.

- that a CSR multi-stakeholder forum be requested to consider whether a common EU approach to SRI can be established.

ABC of CSR

The Directorate-General for Employment & Social Affairs (DG Employment) plays an important role at the EU level in promoting the continued development of CSR and SRI:

'By integrating sustainability commitments in investment decisions, SRI seeks to combine investors' financial goals (e.g. profitability and security of investment) with concerns over an investment's impact on society and the environment. As the pressure comes directly from the companies' owners or shareholders, SRI represents a powerful way to prompt change in companies' behaviour, translating values into positive action and promoting social and environmental progress.'

In its 2004 report, ABC of CSR,¹¹⁰ DG Employment repeats the concerns set out in the Green Paper and the Communication on CSR on issues such as transparency and reporting methodologies:

'The lack of information on SRI performance and of transparent criteria defining SRI as well as of clear and homogenous assessment methodologies are among some of the reasons hindering the development of SRI.'

The Occupational Pensions Directive

The Directive on the activities and supervision of institutions for occupational retirement provision (the Occupational Pensions Directive)¹¹¹ was adopted in June 2003. The directive applies to institutions for occupational retirement provision (IORPs)¹¹² and aims to create an internal market for occupational retirement provision. By clearly setting out how IORPs should function, the Directive ensures a high level of protection for members and beneficiaries of pension funds.

Article 12 of the Directive requires member states to ensure that IORPs draw up and, at least every three years, review a statement of investment policy principles (SIP).¹¹³ The SIP should be made available to the competent authorities and, on request, also to members and beneficiaries of each pension scheme.¹¹⁴

Member states must also ensure that IORPs invest in accordance with the 'prudent person' rule and, in particular, in accordance with the following rules:¹¹⁵

- assets shall be 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 shall be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole (assets held to cover technical provisions should also be invested in a manner appropriate to the nature and duration of the expected future retirement benefits);
- assets shall be predominantly invested on regulated markets;
- investment in derivative instruments shall be possible insofar as they contribute to a reduction of investment risks or facilitate efficient portfolio management; and

¹¹⁰ *ABC of the Main Instruments of Corporate Social Responsibility*, European Commission Directorate-General for Employment and Social Affairs Unit D.1 Manuscript completed in 2004, p.49.

¹¹¹ 2003/41/EC of 3 June 2003.

¹¹² *Ibid.*, at article 2. An IORP is an institution, irrespective of its legal form, operating on a funded basis and established separately from any sponsoring undertaking or trade for the purpose of providing retirement benefits in the context of an occupational activity on the basis of an agreement or contract agreed individually or collectively between the employer(s) and employee(s) or their respective representatives, or with self-employed persons, in compliance with the legislation of the home and host member states, and which carried out activities directly arising from that purpose.

¹¹³ *Ibid.* at article 12.

¹¹⁴ *Ibid.* at articles 11 and 13.

¹¹⁵ *Ibid.* at article 18.

- the assets shall be 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.

Neither the SIP nor these investment rules make express reference to environmental, social or governance considerations nor indeed the best interests of the members and beneficiaries being restricted to the maximisation of financial returns. Importantly, however, during negotiation of the Directive, the Committee on Economic and Monetary Affairs proposed an amendment to article 12 requiring that the SIP would have to contain a statement of institutions’ ‘ethical and socially responsible investment principles’.¹¹⁶ This amendment was not adopted.¹¹⁷

3 PRIVATE SECTOR INITIATIVES

There are a number of pan-European initiatives in the CSR/SRI sector, some notable examples of which are set out below.

European private sector initiatives	
Eurosif ¹¹⁸	The European Social Investment Forum (Eurosif) is a European, non-profit organisation aiming to inform, educate and provide a European network for discussion about sustainable and responsible financial services. By supporting the development of existing social investment fora (SIFs), Eurosif aims to expand the European network and encourage the creation of new national SIFs. ¹¹⁹
CSR Europe ¹²⁰	CSR Europe is the leading European business network for CSR with over 60 leading multinational corporations as members. Since its inception in 1995 by the then European Commission President Jacques Delors and leading European companies, its aim has been to help companies integrate CSR into the way they do business on a daily basis.
Social Platform ¹²¹	The Platform of European Social NGOs (the Social Platform) is the alliance of representative European federations and networks of NGOs active in the social sector. The Social Platform enjoys the support of the European Commission in its commitment to the advancement of the principles of equality, solidarity, non-discrimination and the promotion and respect of fundamental rights for all, within Europe and in particular the EU. It is active in the campaign to raise the profile of CSR and has called for a convergence of CSR practices and tools in the EU and greater transparency regarding investment principles.

¹¹⁶ Draft Report on the Proposal for a European Parliament and Council Directive on the Activities of Institutions for Occupational Retirement Provision, European Parliament, Committee on Economic and Monetary Affairs, (8 May 2001), PE 295.986/AM/48-134, p.52

¹¹⁷ A new Communication from the European Commission on CSR is due to be published towards the end of 2005. As part of the UK Presidency of the European Council of Ministers the UK Government, in partnership with the Commission, will be hosting a conference on CSR and the Finance Sector in December 2005. The focus will be on the role the finance sector can play in driving CSR and the opportunities and challenges faced by mainstream financial institutions in becoming more actively engaged in adopting CSR principles.

¹¹⁸ For further information, see www.eurosif.com.

¹¹⁹ Eurosif have created a *Pension Programme SRI Toolkit* with the support of the European Commission which sets out why trustees should incorporate SRI into their pension fund’s strategy, the benefits of doing this and possible strategies.

¹²⁰ For further information, see www.csreurope.org.

¹²¹ For further information, see www.socialplatform.org.

1 INSTITUTIONAL INVESTMENT

The main types of managed funds in Australia are the following.¹²²

1.1 Superannuation funds

These include regulated superannuation funds (including various forms of pensions), approved deposit funds and pooled superannuation trusts (into which trustees of other superannuation funds invest the assets of those funds). These funds operate as trusts, and the trustee of a fund may or may not be the holder of an Australian financial services licence (AFS licence) depending on the nature of the fund.

1.2 Statutory funds of life insurance companies

Australian life insurance companies must establish separate statutory funds for their life insurance business.¹²³ The expenditure of the statutory fund can relate only to the life insurance business within the statutory fund, and the rights of creditors regarding the life insurance company are subordinated to the rights of the policy owners. In short, the assets of a statutory fund are ring-fenced under all reasonable circumstances to protect policyholders.

The statutory fund is not a trust, and a policyholder does not have equitable rights to the fund or its assets. The statutory fund is simply a product of statute and is not a separate legal entity. The policyholder's rights against the life insurance company are contractual, with duties overlaid by applicable legislation (discussed below).

1.3 Managed investment schemes

These schemes pool individual investments. The investors, in return, acquire rights to benefits produced by the scheme.

The schemes are generally operated by a 'Responsible Entity' (a public company holding an AFS licence authorising it to operate the scheme), which must perform the functions conferred on it by the scheme's constitution and the Corporations Act 2001 (Cth) (the Corporations Act).

Managed investment schemes include cash management trusts, unit trusts (non-listed and listed on an exchange, public and private) and common funds.

Before considering the legal framework that governs the above institutional investors, it should be noted that the management of the funds owned by these institutions is invariably carried out through internal or external investment managers (the latter's duties being contained in an investment management agreement).

¹²² As at the 31 March 2005 quarter, the estimated total consolidated assets of managed funds in Australia (including superannuation funds, life insurance offices and other managed funds) were approximately AUD\$838.7bn (Source: Australian Bureau of Statistics: Managed Funds Australia, data for March 2005 quarter). Total estimated superannuation assets amounted to AUD\$710bn for the March 2005 quarter (Source: Australian Prudential Regulation Authority (APRA) Statistics: Quarterly Superannuation Performance March 2005, Issued 14 July 2005). The profits for life insurance statutory funds as at June 2004 stood at AUD\$1.905bn (Source: APRA Insight First Quarter 2005).

¹²³ This is a requirement of the Life Insurance Act 1995 (Cth) (the *Life Insurance Act*).

2 LEGAL CONTEXT FOR INVESTMENT DECISION-MAKING

The Corporations Act contains a number of statutory duties pertaining to all companies and their directors and officers. These extend to all companies, including companies acting as trustees, insurance companies and Responsible Entities. Of particular relevance are the following:¹²⁴

- exercise the degree of care and diligence that a reasonable person would exercise if they were in the company's position;
- discharge their duties in good faith and in the best interests of the corporation and for a proper purpose; and
- act in good faith, honestly and not improperly use their position or information.

2.1 Superannuation funds

A primary source of duties and obligations for trustees of superannuation funds is the trust deed.¹²⁵ Furthermore, legislation¹²⁶ and policy guidance¹²⁷ are the main tools regulating trustees' conduct, disclosure obligations, licensing etc.

Statutory duties

The trustee of a superannuation trust must ensure that the fund is maintained solely for the purpose of generating and providing monetary benefits to members upon retirement.¹²⁸ This is known as the 'sole purpose test' and cannot be overridden by the terms of the fund's trust deed.

The SIS Act provides that the governing rules of such a trust must contain the following duties applicable to the trustees:¹²⁹

- act honestly in all matters affecting the entity;
- exercise the degree of care, skill and diligence that an ordinary prudent person would exercise in dealing with the property of another for whom the person felt morally bound to provide;
- act in the best interests of beneficiaries;
- not do anything that would impede the proper performance of its functions and powers;
- formulate and give effect to an investment strategy that considers the whole of the circumstances of the entity, including but not limited to (1) the risk involved in making, holding and realising, and the likely return from, the entity's investments having regard to its objectives and its expected cash flow requirements; (2) the duty to diversify investments; and (3) the ability of the entity to discharge its existing and prospective liabilities to manage reserves responsibly; and
- allow a beneficiary access to certain information.

¹²⁴ See sections 180, 181 and 184 of the Corporations Act.

¹²⁵ A standard trust deed will contain details of the rights, powers, and remuneration of the trustee, details of benefits of members, winding up provisions, disclosure, record keeping and actuarial review or audit (amongst other things).

¹²⁶ Namely, Chapter 7 of the Corporations Act, and the Superannuation Industry (Supervision) Act 1993 (Cth) (*SIS Act*) and other superannuation legislation.

¹²⁷ In the form of the Australian Securities and Investments Commission (*ASIC*) Policy Statements and other instruments, as well as APRA Circulars.

¹²⁸ Section 62 of the SIS Act.

¹²⁹ In the absence of express provisions, section 52 of the SIS Act provides that such covenants will be deemed to be included in the governing rules of the fund.

Common law duties

Similar common law duties apply to trustees of superannuation funds as those applying to Responsible Entities of managed investment schemes, as set out below.

2.2 Insurance reserves

A number of instruments regulate the operation of insurance companies.¹³⁰ The APRA, in particular, focuses on the prudential regulation of life insurance companies and statutory funds.

Specific regulation of the statutory fund itself, on the other hand, is carried out primarily under the Life Insurance Act,¹³¹ which requires a life insurance company to comply with rules concerning the establishment, maintenance and investment of statutory funds and give priority to the interests of owners, and prospective owners, of policies referable to the fund viewed as a group.

The Life Insurance Act contains a range of more detailed duties and requirements on investment and management of statutory funds (please see below).

Statutory duties

The Life Insurance Act sets out various requirements on permissible applications of statutory fund assets.

Briefly, both the life company and its directors are obliged¹³² to take reasonable care, and use due diligence, to see that in the investment, administration and management of the assets of a statutory fund, the company gives priority to the interests of owners, and prospective owners, of policies referable to the fund (viewed as a group). These duties are statutory duties rather than general law fiduciary duties.

The Life Insurance Act further requires¹³³ that the assets of the statutory fund be invested in a way that is likely to 'further the business of the fund'.

Common law duties

A life insurance company's common law duties include:

- the general duty of care;
- the duty to act in good faith and exercise powers for proper purposes; and
- the duty of utmost good faith,¹³⁴ which is binding on both the insured and the insurer (although the duty is less frequently applied against the insurer).

2.3 Managed investment schemes

The conduct of the Responsible Entity is regulated by a range of instruments.¹³⁵ This regulatory framework covers, among other things, registration by the Australian Securities and Investments Commission (ASIC) of most funds.

The main duties and obligations of fund managers are usually contained in the constitution and compliance plan for the scheme, as well as any applicable investment management agreement. The

¹³⁰ Namely, Chapter 7 of the Corporations Act, the Life Insurance Act, Actuarial Standards, the Insurance Act 1973 (Cth), the Insurance Contracts Act 1984 (Cth) and APRA Prudential Standards and Rules for Life Insurance and APRA Circulars.

¹³¹ The Actuarial Standards and APRA Prudential Standards will also apply.

¹³² Under section 48 of the Life Insurance Act.

¹³³ Under section 43(2).

¹³⁴ *Carter v Boehm* (1766) 3 Burr 1905: 'Good faith forbids either party by concealing what he privately knows, to draw the other into a bargain, from his ignorance of the fact, and his believing the contrary.'

¹³⁵ Namely, legislation (Chapters 5C and 7 of the Corporations Act) and policy issued by ASIC in the form of Policy Statements, Class Orders and other instruments.

constitution outlines a number of matters affecting the operation of the scheme, while the compliance plan details the measures to be taken to ensure compliance with the Corporations Act and Constitution.

Statutory duties

The Corporations Act contains a number of duties pertaining to Responsible Entities of managed investment schemes and their officers and employees. The duties of a Responsible Entity include the duty to:

- act honestly;
- exercise the degree of care and diligence that a reasonable person would exercise if they were in the Responsible Entity's position;
- act in the best interests of the members and, if there is a conflict between the members' interests and its own interests, give priority to the members' interests;
- ensure that scheme property is valued at regular intervals appropriate to the nature of the property, clearly identified as scheme property and held separately from the property of the Responsible Entity; and
- comply with the scheme's constitution and compliance plan.¹³⁶

Common law duties

A Responsible Entity's statutory duties co-exist with its common law duties. A number of general law trustee duties apply to a Responsible Entity who is a trustee (ie holds scheme property), including duties to:

- adhere to and carry out the terms of the trust;¹³⁷
- act impartially between the beneficiaries;¹³⁸
- properly invest the trust funds; and
- exercise reasonable care.¹³⁹

Where the Responsible Entity is not a trustee (for example, where scheme property is not within the possession of the Responsible Entity, such as where legal title to this property is held by a custodian), similar duties will still apply. Other fiduciary duties that exist at common law include:

- the duty of honesty and loyalty;¹⁴⁰
- the duty to prioritise members' interests over its own interests;¹⁴¹
- the duty of impartiality;¹⁴²
- the duty not to misuse information; and
- the duty of care and diligence.¹⁴³

¹³⁶ See sections 601FC, 601FD and 601FE of the Corporations Act.

¹³⁷ See for example, *Youyang Pty Ltd v Minter* (2003) 77 ALJR 895.

¹³⁸ See *Equitiloan Ltd v ASC* (2003) ACLC 1,056.

¹³⁹ In situations where the Responsible Entity holds scheme property and is therefore trustee for scheme members, it will owe to the scheme members the duties of a trustee (as outlined): see *Re Mirvac Ltd & Ors* (1999) 17 ACLC per Austin J.

¹⁴⁰ *National Trustees Co of Australia Ltd v General Finance Co of Australia Ltd* [1905] AC 373.

¹⁴¹ *Cowan v Scargill* [1984] 3 WLR 501.

¹⁴² *Howe v Lord Dartmouth* (1802) 7 Ves 137; ER 36.

¹⁴³ *Australian Securities Commission v AS Nominees Ltd* (1995) 18 ACSR 459.

3 INTEGRATION OF ESG CONSIDERATIONS INTO INVESTMENT DECISION-MAKING

Whereas the US has led the ESG market, Australia has been slower to adapt. Australian commentators suggest that some of the key factors contributing to the relatively slow growth of ESG in Australia are:¹⁴⁴

- definitional issues and confusion over what constitutes ESG;¹⁴⁵
- the perception that ESG funds underperform when compared with the broader market – although anecdotal evidence on the performance of a number of Australian ESG funds suggests this is not the case, there is a lack of empirical research supporting this conclusion;¹⁴⁶
- confusion over whether ESG is consistent with fund managers' fiduciary responsibilities to their fund members or investors – which is associated with the perception that ESG is a poor performer when compared to the broader market because it results in a restriction of the 'investable universe';
- a lack of superannuation fund choice for employees – until recently, employees have not been able to direct their employers on where to invest compulsory employer superannuation contributions but new legislation¹⁴⁷ allows employees to choose where these funds are invested, enabling employees to choose superannuation funds adopting ESG strategies; and
- a lack of investor demand.

In Australia, active retail funds managers engaging in ESG investment include Hunter Hall, Tyndall, Tower Asset Management (formerly Friends Provident), Australian Ethical Investment and Challenger.¹⁴⁸ Of wholesale funds managers, Westpac Investment Management is the most prominent.¹⁴⁹

Guidance from English courts

As at the date of this report, there is no case law in Australia dealing specifically with fiduciary duties and the implementation of ESG considerations into investment decision-making, but commentary suggests that English cases¹⁵⁰ provide the best guidance on how the issue might be dealt with by Australian courts.¹⁵¹

Australian commentary

As mentioned above, Australian fund managers have traditionally taken the view that ESG investment is inconsistent with the fulfilment of their fiduciary obligations, including the duty to maximise return for the beneficiaries. There are two key reasons for this. First, there is a perception that ESG investments perform poorly in terms of financial returns when compared with more traditional

¹⁴⁴ The Allen Consulting Group, op. cit. pp. 49 to 51. See also Ali and Gold, op. cit. p. 27.

¹⁴⁵ Australian commentators have remarked that, as is the case in other parts of the world, one of the hindrances to the emergence of ESG in Australia is posed by the definitional difficulties associated with ESG. The notion of ESG imports various moral and ethical assumptions, which are largely subjective. This subjectivity creates difficulties in defining the ethical parameters of acceptable investment.

¹⁴⁶ See eg *The Investment Implications of Choosing an SRI Fund*, Feb 2002, cited in Ali and Gold op. cit. p.19.

¹⁴⁷ The Superannuation Legislation Amendment (Choice of Superannuation Funds) Act 2005 (Cth).

¹⁴⁸ The Allen Consulting Group, op. cit. p.21.

¹⁴⁹ Ibid.

¹⁵⁰ As discussed in the UK section of the report below, the leading English cases considering this issue are the decisions of *Cowan v Scargill* [1984] 3 WLR 501 at 513-524; and *Harries v Church Commissioners* [1992] 1 WLR 1241, which are generally perceived to establish the duty to maximise profits for the beneficiaries.

¹⁵¹ Halsbury's Laws of Australia refers to the English case law in outlining the Australian law on this point (at [400-300]).

investments. Second, the conventional view in Australia is that ethical investments create a more volatile portfolio, as they can restrict diversification and increase the risk weighting of the portfolio.¹⁵²

However, recent Australian commentary suggests that where an investment decision has been made on the basis of a ‘modern portfolio’ approach, which justifies the inclusion of a variety of risky and non-risky investment options provided the overall investment yields a positive financial result, a fiduciary will not be in breach of its obligations and may safely pursue an ESG strategy:

‘It is possible for fund assets to be legitimately deployed with the aim of improving labour or environmental standards, human rights or animal welfare provided that, in the pursuit of those goals, the above-stated financial objective is not disregarded or subordinated to the non-financial goals.’¹⁵³

Commentator Andrew Leigh notes that some UK case law has shown that where a fiduciary is able to ‘disguise’ its ethical investment decisions as financial, by stating that their principal aim is to maximise economic return, this may effectively constitute a defence.¹⁵⁴ He cites as an example the investment policy of the trustees in *Harries v Church Commissioners*¹⁵⁵ which was upheld by the court as legitimate. The essence of the policy (reproduced in page 1249 of the judgment) was:

‘The primary aim in the management of our assets is to produce the best total return, that is capital and income growth. While financial responsibilities must remain of primary importance (given our position as trustees), as responsible investors we also continue to take proper account of social, ethical and environmental issues... As regards our Stock Exchange holdings this means we do not invest in companies whose main business is armaments, gambling, alcohol, tobacco and newspapers... We do not invest in any South African company nor in any other company where more than a small part of their business is in South Africa.’

Other commentators point to market analysis and literature to argue that investments made on the basis of ESG considerations can in fact result in equally or better performing stock. Hoggett and Nahan, however, also point to market figures to advance their argument that financial performance and social responsibility do not go together.¹⁵⁶

Superannuation funds – the ‘sole purpose test’

Traditionally, Australian superannuation fund managers have taken the view that the sole purpose test¹⁵⁷ precludes them from undertaking investment decisions based wholly or primarily on ESG considerations.

However, it has been suggested by some commentators, such as Andrew Leigh, that there may be scope within the superannuation legislation for trustees to take non-financial considerations into account when making investment decisions.¹⁵⁸ Leigh argues the test under section 62 may actually be a dominant purpose test.¹⁵⁹ He argues that this can be inferred from the judgment of Pincus J in *Federal Commissioner for Taxation v Roche*, where he stated:

¹⁵² Donnan, Regulating ethical investment: Disclosure under the Financial Services Reform Act, *Journal of Banking and Finance Law and Practice*, 13(3) (September 2002) 155, p.170.

¹⁵³ Ali and Gold, op. cit. It has been suggested that an Australian Court would follow UK decisions, such as that in *Nestle v National Westminster Bank* (English High Court, 19 June 1988), in which Hoffmann J held that modern trustees should be judged on the basis of portfolio theory, which emphasises the risk level of the portfolio as a whole; see Andrew Leigh, ‘Caveat Investor: The Ethical Investment of Superannuation in Australia’ (1997) 25 *Australian Business Law Review* 341, p.347.

¹⁵⁴ Andrew Leigh, ‘Caveat Investor’: The Ethical Investment of Superannuation in Australia’ (1997) 25 *Australian Business Law Review* 341, p.348, referring to *Cowan v Scargill* [1984] 3 WLR 501 and *Harries v Church Commissioners* [1992] 1 WLR 1241.

¹⁵⁵ [1992] 1 WLR 1241.

¹⁵⁶ Hoggett and Nahan, *The Financial Services Reform Act: A Costly Exercise in Regulating Corporate Morals*, August 2000, IPA Backgrounder Vol 14/1, p.10.

¹⁵⁷ Discussed at section entitled “legal context for investment decision-making” above.

¹⁵⁸ Leigh, op. cit., p. 343.

¹⁵⁹ Leigh op. cit., p.343.

'[I]t is my opinion, however, that a fund may be maintained for a purpose within s 23F [the old sole purpose test], even if an important reason for its having been established and maintained is the obtaining of tax concessions'.¹⁶⁰

This would allow superannuation fund trustees who take social or environmental factors into account to satisfy the test, so long as their overriding aim or purpose was still the provision of monetary benefits to members upon retirement.

However, APRA (the government body responsible for regulating the superannuation industry in Australia) and its predecessor, the Insurance and Superannuation Commission, view section 62 as a sole purpose test,¹⁶¹ as do a number of other commentators.¹⁶²

Leigh argues that an alternative way for superannuation fund managers to comply with section 62, where they consider non-financial factors, is to argue that 'purpose' refers to an end rather than a means.¹⁶³ This argument stems from an interpretation of the judgment of Davies J in *Raymor Contractors Pty Ltd v Federal Commissioner for Taxation*, who stated:

'[T]he word 'purpose' has a meaning which is readily understood. It refers to the end in view. When used in a statute, the term requires an act or transaction to have the object of achieving the end specified by the statute'.¹⁶⁴

On the basis of this reasoning, Leigh argues that environmental, social and ethical investments are simply the means to an end (namely the provision of retirement benefits to members), rather than ends in themselves.

Other commentators have suggested yet another approach to overcoming the argument that the sole purpose test prevents superannuation fund managers from taking non-financial considerations into account in managing their funds. Under the SIS Act, all superannuation trustees are required to formulate an investment strategy.¹⁶⁵ If the trustee can show that the investment was made in accordance with an investment strategy, albeit a strategy informed by ESG issues, the SIS Act provides a defence to a claim for loss or damage.¹⁶⁶ A trustee will therefore not be strictly precluded from adopting an ESG strategy, provided that the strategy is primarily for the purposes of investment, and not purely for social or ethical objectives.¹⁶⁷

Additionally, a trustee may pursue an ESG strategy on the basis of beneficiary preference, and provided sufficient evidence is given to show that the investment will provide an economic benefit to beneficiaries (and thereby still meet the sole purpose test):

'As long as the ethical investment option, including an analysis of costs and risk/return profile, have been explored and comprehensively explained to members, then trustees' legal obligations are met'.¹⁶⁸

Investment disclosure legislation – Section 1013D(1) of the Corporations Act

The Financial Services Reform Act 2001(Cth) introduced a new part 7 into the Corporations Act. The reforms require (among other things) issuers of financial products to give retail clients a Product Disclosure Statement (PDS) containing specified information before the client is issued with certain

¹⁶⁰ (1991) ATC 5024 at 5027.

¹⁶¹ Insurance and Superannuation Commission, Superannuation Circular III.A.4. The Sole Purpose Test and Ancillary Purposes, 1995.

¹⁶² See CCH Australian Superannuation Law and Commentary [3-610], A. Fairly, *Sole Purpose Test Takes On Own Persona* (1995) 30(5) *Australian Lawyer* 29.

¹⁶³ Leigh, op. cit., p. 343.

¹⁶⁴ (1991) ATC 4259 at 4260.

¹⁶⁵ Section 52(2)(f).

¹⁶⁶ Section 55(5).

¹⁶⁷ Ali and Gold, op. cit., p.16; see also E. O'Dell, Incapacity in P.B.H. Birks and F. Rose, *Lessons of the Swaps Litigation*, 2000; P.U. Ali and T. Russell, 'Investor Remedies against Fiduciaries in Rising and Falling Markets' (2000) 18 *Corporate and Securities Law Journal* p.326, 329-330.

¹⁶⁸ Phillip Spathos, lawyer, IFS Fairley, quoted in A. Driver, *Super Review* (May 2000) 20, p.22.

financial services or products. The Act, among other things, introduced section 1013D(1)(l) into the Corporations Act.

The new section requires the PDS for products with an investment component to include disclosure about ‘the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment. Products with an investment component include superannuation products, managed investment products and investment life insurance products’.¹⁶⁹

Product issuers must include as much of the above information as a person would reasonably require to make the decision, as a retail client, about whether to acquire the financial product.¹⁷⁰ Reasonableness is to be assessed from the retail client’s, not the product issuer’s, perspective.¹⁷¹

The new requirement of section 1013D(1)(l) is based on an amendment to the Occupational Pensions Scheme (Investment) Regulations 1996 in the UK, which commenced operation on 3 July 2000 (please see the UK section below).

The Corporations Regulations 2001

Under section 1013D(4) regulations can be made to set out in more detail the information required in a PDS. The Corporations Regulations 2001 now require the PDS to state either:

- that labour standards or environmental, social or ethical considerations have *not* been taken into account; or, if one or more of those considerations *have* been taken into account:
 - which of the specific considerations have been taken into account;
 - the standards and considerations that the issuer considers to be labour standards, environmental, social or ethical considerations respectively; and
 - the extent to which they were taken into account in selecting, retaining or realising an investment.¹⁷²

ASIC guidelines

ASIC has released binding guidelines entitled Disclosure: Product Disclosure Statements (and other disclosure obligations), which provide guidance for product issuers on preparing a PDS. These guidelines set out requirements that apply in cases where a PDS claims that labour standards or environmental, social or ethical standards have been taken into account in investment decisions.¹⁷³

The guidelines require product issuers to provide retail clients with sufficient detail regarding the methodology for taking the relevant standards or considerations into account; any weighting system used with respect to the standards and considerations; and a description of the product issuer’s retention and realisation policies. The PDS must include a general description of whether adherence to the methodology will be monitored or reviewed, whether there is a timeframe for monitoring or reviewing investments, and an explanation of what will happen when an investment no longer matches the stated investment policy. The guidelines also state that a PDS must set out any specific criteria or mechanisms used for measuring standards or considerations, and state where a client can find out more about the approach used.

¹⁶⁹ Section 1013D(2A).

¹⁷⁰ Section 1013D(1).

¹⁷¹ ASIC, Section 1013DA Disclosure Guidelines, December 2003, p.11.

¹⁷² The Corporations Act sets out a number of offences relating to providing someone with a defective PDS. See, for example, sections 1021D, 1021E and 1021F. ASIC has stated that it will consider taking regulatory action where the way information is presented in a PDS actually impedes the consumer from making an informed decision about whether to acquire a financial product. (ASIC IR 04-71, 21 December 2004).

¹⁷³ ASIC, Disclosure: Product Disclosure Statements (and other disclosure obligations) [PS 168], updated May 2005.

Obligation or choice?

The Corporations Act disclosure laws do not state that a product issuer *must* take labour standards or environmental, social or ethical considerations into account. They simply require the PDS to explicitly state whether or not such considerations have formed part of the selection, retention or realisation process (and if so, how).

However, some commentators argue that in reality there is no choice because if a product issuer stated that it did *not* consider labour standards or environmental, social or ethical considerations, pressure groups and the media would label the product issuer as unethical and antisocial.¹⁷⁴

The Australian Conservation Foundation, whose submission resulted in the disclosure requirement in section 1013D(1)(l) being included in the legislation, also recognised that given the current consumer demand for ESG products¹⁷⁵ providers of financial products will be highly reluctant to make a negative disclosure with respect to the full range of their products and will most likely ensure that there is at least one, if not more, ESG products are available within their product range.¹⁷⁶

In practice, these forecasts have hardly been substantiated: only a relatively small number of PDSs indicate that labour standards or environmental, social or ethical issues have been considered in the selection, realisation or retention of investments. Moreover, in many cases where product issuers state that they have not taken these considerations into account (as they are required to do under the Corporations Regulations), the rationale given for this decision is a desire to maximise financial returns to members and beneficiaries.

The Corporations Act investment disclosure laws and fiduciary duties

A major point of contention regarding the new investment disclosure provisions discussed above is whether or not taking labour standards or environmental, social or ethical considerations into account when choosing investments can conflict with the fiduciary duty of fund managers.

Some commentators argue that the recognition in the Corporations Act that investment choices can be made on such grounds would seem to override fiduciary duties to the extent of any inconsistency.¹⁷⁷

However, commentators such as Julian Donnan doubt that courts would accept this argument. First, he points out that the Corporations Act disclosure laws relate only to disclosure and not to the broader regulatory regime and general law principles under which funds operate. Second, he argues that investing 'ethically' and observing fiduciary duties are not necessarily mutually exclusive activities. Fiduciary duties can co-exist with environmental, social or ethical considerations, provided that trustees place the financial interests of their beneficiaries ahead of these considerations. It is also arguable that there is no indication of the considerable legislative intent necessary to override the entrenched equitable doctrine of fiduciary duty.¹⁷⁸

¹⁷⁴ Donnan, op. cit., p.3.

¹⁷⁵ A study conducted by KPMG in 2000 revealed that 69 per cent of Australians would consider a socially responsible fund if given the opportunity, *Report on the Financial Services Reform Bill 2001, Parliamentary Joint Statutory Committee on Corporations and Securities*, para. 5.167.

¹⁷⁶ *SRI Disclosure within the Financial Services Reform Act*, Australian Conservation Foundation (www.acfonline.org.au.)

¹⁷⁷ See, for example, Manning, Super Trustees Can Invest Ethically, *Ethical Investor* at 18 October 2001 cited in Donnan, op. cit., p. 170.

¹⁷⁸ Ibid.

1 INSTITUTIONAL INVESTMENT

Canada's main institutional investors comprise the following.¹⁷⁹

1.1 Pension funds

Pension funds are typically administered as trusts, with trustees who are independent of the sponsoring employer (whether a private business or state entity) acting as custodians of the assets of the fund. In most cases, pension plans of this type are required to be registered to receive certain tax benefits.

1.2 Life insurance companies

Life insurance companies maintain considerable investments to meet liabilities under policies they issue.

1.3 Mutual funds

Mutual fund companies are financial intermediaries that sell units to investors and invest the money they receive, usually in accordance with a specific investment mandate that is made known to investors before they subscribe.

2 LEGAL CONTEXT FOR INVESTMENT DECISION-MAKING

2.1 Pension funds

Investment of the assets held in respect of a registered pension plan (RPP) in Canada gives rise to fiduciary (or fiduciary-like) obligations both at common law and under provincial or federal pension benefits legislation. In general, the prudent person/portfolio approach is mandated by legislation in Canada and RPPs are also subject to modest but specific investment rules set out in legislation that limit the way pension fund assets may be invested.

2.2 Trustee legislation

As trustee legislation across Canada falls under provincial jurisdiction,¹⁸⁰ the specific statutory standard of care to which a trustee will be held when investing the trust property varies, but is typically that of a prudent person.

For example, when investing trust property in Ontario a trustee must exercise the care, skill, diligence and judgement that a prudent investor would exercise in making investments.¹⁸¹ However, the parties to the trust agreement can specify that the trustee legislation does not apply.¹⁸²

In general, where the trustee legislation conflicts with pension benefits legislation, the pension legislation will prevail.

2.3 Pension benefits legislation

Fiduciary obligations (prudent person requirement)

In most provinces¹⁸³ the applicable pension legislation¹⁸⁴ has imposed a statutory prudent person requirement on the administrator¹⁸⁵ of the pension plan with respect to the investment of the pension

¹⁷⁹ The Governance Practices of Institutional Investors (Report of the Standing Senate Committee on Banking, Trade and Commerce), November 1998.

¹⁸⁰ See, for example, the Ontario *Trustee Act*, R.S.O. 1990, c.T.23.

¹⁸¹ *Ibid.*, s. 27(1).

¹⁸² *Ibid.*, s. 66.

¹⁸³ For ease of expression, the term 'provinces' will be used in this analysis. However, it should be noted that in Canada there is separate federal pension standards legislation that applies to pension arrangements provided to individuals whose employment is federally regulated. Accordingly, reference to "provinces" should generally be construed to include the federal jurisdiction.

fund (see Appendix). For example, in Ontario the administrator of a pension plan is required to ‘exercise the care, diligence and skill in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person’.¹⁸⁶

In a minority of provinces, the pension legislation addresses the duty of prudence regarding the investment of pension plan assets more specifically. For example, in British Columbia ‘pension plan investments, loans and other pension plan financial decisions must be made ... in the best financial interest of plan members, former members and other beneficiaries’,¹⁸⁷ while in Alberta investments must be made ‘in a manner that a reasonable and prudent person would apply to the plan’s portfolio of investments having regard to the plan’s liabilities’.¹⁸⁸

Pension benefits legislation – investment rules

In addition to the fiduciary duties (both general and pensions-specific) outlined above, pension plan administrators are subject to statutory investment rules.

The administrator is required to establish a statement of investment policies and procedures for the pension plan (SIPP), specifying the categories of investments and the diversification of the investment portfolio.¹⁸⁹ The SIPP is intended to promote thoughtful investment and requires due consideration of plan liabilities.

Pension plans falling under federal jurisdiction must comply with the investment rules set out in the Pension Benefits Standards Act, 1985 (Canada)¹⁹⁰ and the related regulations¹⁹¹ (the Federal Investment Rules).¹⁹² Of the greatest relevance is the duty of diversification of investment established by the Federal Investment Rules.¹⁹³

2.4 Common law

There is very little Canadian common law jurisprudence regarding the proper investment of pension fund assets. Generally, the common law standard of care required of a trustee is that which a person of ordinary prudence would use in managing his or her own affairs.¹⁹⁴ This needs to be adapted to the

¹⁸⁴ See, for example, the Ontario *Pension Benefits Act*, R.S.O.1990, c.P.8.

¹⁸⁵ Depending on the province, the administrator of a pension plan is typically the employer, but may also be a pension committee. In some provinces, such as Quebec, the plan must be administered by a pensions committee composed of members of the pension plan and the employer.

¹⁸⁶ *Pension Benefits Act*, R.S.O. 1990, c. P.8, s. 22(1).

¹⁸⁷ *Pension Benefits Standards Act*, R.S.B.C. 1996, c. 352, s. 44(1).

¹⁸⁸ *Employment Pension Plans Act*, R.S.A. 2000, c. E-8, s. 54.

¹⁸⁹ For example see the regulations under the *Pension Benefits Standards Act, 1985*, R.S.C. 1985, c. 32, ss. 7.1-7.2 and the non-binding “OSFI Guideline for the Development of Investment Policies and Procedures for Federally Regulated Pension Plans” dated April 2000. While it does not make reference to “modern portfolio theory” (instead it refers to “prudent person portfolio” approach), it is evident from the Guideline that the SIPP should reflect a global approach to the total portfolio and that investment strategies should take into account overall pension plan needs (including cash flow) and its particular risks. The Guideline may be found at www.osfi-bsif.gc.ca/app/DocRepository/1/eng/pension/guidance/penivst_e.pdf

¹⁹⁰ RSC 1985, c. 32.

¹⁹¹ *Pension Benefits Standards Regulation, 1985*, S.O.R./87-19, ss. 6, 7, 7.1, 7.2 and Schedule III.

¹⁹² The Federal Investment Rules have been incorporated by reference into most provincial pension benefits legislation (or similar rules have been adopted), although Quebec and New Brunswick have their own investment rules. For Quebec’s investment rules see the *Supplemental Pension Plans Act*, R.S.Q. c. R-15.1, ss. 169-182. For New Brunswick’s investment rules see the regulation under the *Pension Benefits Act*, S.N.B. 1987, c. P-5.1, ss. 44-46.1.

¹⁹³ Namely, a pension fund is prevented from exposing more than 10% of its assets to the fortunes of any one company (or other entity) and its affiliates. Those other key restrictions are the prohibition on owning more than 30% of a company’s voting shares; there are additional restrictions related to investment into real estate and investment into securities of a “related party”.

¹⁹⁴ *Fales v. Canada Permanent Trust Co.*, [1977] 2 S.C.R. 302.

notion of a prudent portfolio approach endorsed in the pension standards statutes and the regulators' views of same.¹⁹⁵

The case most often referred to as establishing the standard of care required of pension trustees when investing the assets of a pension fund is the decision of Sir Robert Megarry V-C in *Cowan v Scargill*¹⁹⁶ (*Scargill*, discussed further in the UK section below). For example, in her text 'The Law of Trusts', Madame Justice Eileen Gillese (who is regularly quoted in the area of pension and trust law) cites *Scargill* in support of the following observations:

*'In order to meet the standard of care, the trustee should be guided by, at least, these four principles. First, the trustee must be even-handed between beneficiaries interested in income and those interested in capital. Second, the trustee must act honestly. Third, the trustee must not select speculative or unduly risky investments. Fourth, trustees are not to invest on the basis of political or social/economic belief.'*¹⁹⁷

The *Scargill* decision also notes as follows: 'When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests. In the case of a power of investment... the power must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risks of the investments in question...'.¹⁹⁸

Perhaps emanating from *Scargill* and other cases, the duty of trustees is frequently referred to as a duty to maximise returns without undue risk of loss.¹⁹⁹ Contrary opinions have been expressed²⁰⁰ but these have not received judicial approval; indeed, as noted, no Canadian court has been asked to rule on the proper exercise of powers of investment.

It is generally accepted that the power of investment is undertaken in a prudent manner when adequate processes (including completion of studies of the nature and quality of a proposed investment in light of the plan's total assets and obligations) have been followed and salient information (including expert opinions) has been considered. An investment cannot be judged as imprudent, where appropriate, merely because it was unsuccessful, and similarly a successful investment may not be prudent merely because of that fact. It is well accepted at common law that prudence is to be determined when the investment is made (as well as at meaningful intervals thereafter, during which a review of the portfolio should be undertaken) rather than by results.

2.5 Insurance company reserves

Insurance companies are not subject to fiduciary duties in relation to the management of their investments, but they must follow a prudent person approach to investment to avoid undue risk of loss and obtain a reasonable return. For example, the directors of federally incorporated insurance companies must comply with statutory investment limits²⁰¹ and establish and adhere to investment and lending policies, standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments and loans to avoid undue risk of loss and obtain a reasonable return.²⁰² National Corporate Governance Guidelines, which apply to public companies, contain a requirement for a written code of business conduct and ethics that addresses issues such as conflict of interests and the proper use of corporate assets and opportunities.²⁰³

¹⁹⁵ See, for example, the OSFI Guideline identified *supra*.

¹⁹⁶ [1984] 3 WLR

¹⁹⁷ Ellen E. Gillese, *The Law of Trusts*, (Toronto: Irwin Law Inc., 1997) at 137.

¹⁹⁸ [1984] 3 WLR 501 at 513.

¹⁹⁹ See comment of the Manitoba Law Reform Commission, *infra*.

²⁰⁰ See eg. Yaron, 'Answers to Common Questions' (Share, 2001).

²⁰¹ For example sections 503 and 504 of the *Insurance Companies Act* (Canada) limit the amount of commercial lending by federally regulated life insurance companies.

²⁰² *Insurance Companies Act*, R.S.C. 1991, c. 47, s. 492.

²⁰³ See National Policy 58-201, Corporate Governance Guidelines.

2.6 Mutual funds

The regulation of mutual funds in Canada takes place at the provincial level; however, there are certain national ‘rules’, including National Instrument 81-102 Mutual Funds, which has been adopted under all provincial securities legislation and restricts the types of investments mutual funds can make. For example, some restrictions address conflict of interest issues, while other restrictions prevent mutual funds from purchasing a security for the purpose of exercising control over or management of the issuer of that security.

3 INTEGRATION OF ESG CONSIDERATIONS INTO INVESTMENT DECISION-MAKING

3.1 Pension funds

There is no legislation or government guidance granting a mandate to pension trustees/administrators to take ESG concerns into account ahead of the financial interests of beneficiaries.

Some pension funds have included ESG issues within the context of profit maximisation. The Ontario Municipal Employees Retirement System (OMERS), for example, has addressed ESG considerations in its SIPP²⁰⁴ and proxy voting guidelines.²⁰⁵ OMERS’ social responsible investing policies²⁰⁶ consider social, ethical and environmental issues within the broader context of maximising long-term shareholder value. For example, its SIPP provides as follows: ‘As part of our due diligence in researching investments and monitoring performance, we take non-financial factors into consideration in terms of their potential impact on future returns.’²⁰⁷

Similarly, in their corporate governance policy on social responsibility, the Ontario Teachers’ Pension Plan Board states that their fiduciary duty is to ‘obtain the highest return for the plan commensurate with acceptable levels of risk’ and as a result ‘non-financial’ considerations will not be considered ahead of ‘risk and return considerations’. However, the policy does note that ‘careful consideration of social responsibility issues by companies and their board will enhance long-term shareholder value’.²⁰⁸

The Canada Pension Plan Investment Board²⁰⁹ (CPPIB) established a social investment policy in March 2002. The policy states that the CPPIB will not accept or reject investments based on non-investment criteria (such as positive or negative screens based on religious, social or environmental criteria). However, it also states that the CPPIB believes responsible corporate behaviour generally contributes to enhanced long-term investment returns.²¹⁰

Moving beyond the idea that the integration of ESG is acceptable if there is evidence of improved corporate performance as a result, Manitoba’s trustee legislation contains a unique provision that a trustee who uses non-financial criteria to prepare an investment policy or make investment decisions does not automatically breach the trust provided he or she exercises the judgement and care that a

²⁰⁴ See section 10 of OMERS Statement of Investment Policies and Procedures, www.omers.com/userfiles/page_attachments/Library/1/OMERSSIP_P_429428.pdf.

²⁰⁵ See section E of the Proxy Voting Guidelines www.omers.com/userfiles/page_attachments/Library/1/pvg_3542832.pdf.

²⁰⁶ For a brief general background to OMERS SRI policies see: www.omers.com/English/OMERS-leads-the-way-in-SRI-policy.html.

²⁰⁷ OMERS Statement of Investment Policies and Procedures, op. cit., section 10.

²⁰⁸ See OTPP Corporate Governance Policy on Social Responsibility, www.otpp.com/web/website.nsf/web/Guidelines_SocialResponsibility, OTPP Investment Strategy available online at www.otpp.com/web/website.nsf/web/investmentstrategy, OTPP policy statements on Selecting Stocks and Ethical Screens, www.otpp.com/web/website.nsf/web/InvestmentBasics_SelectingStocks. Also see the comments of the OTPP CEO available online at [www.otpp.com/web/website.nsf/web/CLamoureux_EthicalInvesting/\\$FILE/EI_Speech2000.pdf](http://www.otpp.com/web/website.nsf/web/CLamoureux_EthicalInvesting/$FILE/EI_Speech2000.pdf).

²⁰⁹ The CPPIB was created in 1997 to manage investments under the national state (except for Quebec) pension scheme applicable to all employees.

²¹⁰ See CPPIB Social Investing Policy, available online at www.cppib.ca/who/policy/Social_Investing_Policy.pdf.

person of prudence, discretion and intelligence would exercise in administering the property of others.²¹¹ The provision was based on a recommendation made by the Manitoba Law Reform Commission in a report on ethical investment by trustees, which concluded:²¹²

'The law should make it clear that the consideration of non-financial criteria is not imprudent or improper per se, so long as it does not displace the primary obligation of maximizing the financial benefit of the trust. In our view, The Trustee Act, should be amended to dispel the suggestion that the use of non-financial criteria in investment policy is necessarily proscribed. The balance to be achieved should be the creation of a defined scope for the proper consideration of non-financial criteria on the one hand, with the fundamental need to protect the financial benefits, on the other hand.'

In spring 2005, assent was given to amendments to Manitoba's pension legislation containing language on non-financial investment considerations (similar to the language in Manitoba's trustee legislation), although the amendments have yet to come in force. The amends are as follows:²¹³

'Unless a pension plan otherwise provides, an administrator who uses a non-financial criterion to formulate an investment policy or to make an investment decision does not thereby commit a breach of trust or contravene this Act, if in formulating the policy or making the decisions, he or she has complied with subsections (2) and (2.1).'

Subsection 28.1(2) addresses the general standard of care²¹⁴ and subsection 28.1(2.1) addresses the standard of care applicable to the investment of pension assets.²¹⁵

The provisions in Manitoba's trustee and pension legislation are the first instance where non-financial considerations have been specifically addressed in Canadian trustee legislation or pension legislation and provide some legislative recognition of ESG considerations. While this is a key development, it would be overstating the scope of the legislation to suggest that it affords an absolute safe harbour for ESG considerations. Rather, both the trustee legislation and pension legislation in Manitoba simply recognise that non-financial considerations are not prohibited in and of themselves, but require that the trustee or administrator still satisfy the requisite standard of care.

It remains to be seen whether other provinces will adopt provisions similar to those in Manitoba. In one instance, the above noted provision from Manitoba's trustee legislation was considered (and ultimately rejected) in a report on trustee investment powers for the British Columbia Law Institute. On the topic of ethical and philosophical criteria for investment selection, the report reached the following recommendation:

*'There should be no change in the law regarding the application of non-financial criteria (e.g. ethical and philosophical criteria) for investment selection by trustees. Application of non-financial criteria must be authorised by the terms of the trust if the trustees are to be excused from liability for obtaining a lower rate return than conventional financial investment criteria would produce.'*²¹⁶

3.2 Insurance reserves

There appears to be some scope for integrating ESG considerations in the insurance arena. However, in practice, this may be limited at the present time, given that the insurance industry is highly regulated (including via various prescribed limits on the nature and concentration of investment), as well as the

²¹¹ *Trustee Act*, C.C.M., c. T160, s. 79.1.

²¹² Manitoba Law Reform Commission, 'Ethical Investments by Trustees' (Winnipeg: Manitoba Law Reform Commission, January 1993).

²¹³ Bill 10, *The Pension Benefits Amendment Act*, 3rd Sess., 38th Leg., Manitoba, 2005 (assented to April 19, 2005).

²¹⁴ *Ibid.*, s. 28.1(2): "The administrator or a pension plan shall exercise the care, diligence and skill in the administration of the plan and the pension fund that a pension of ordinary prudence would exercise in dealing with the property of another person."

²¹⁵ *Ibid.*, s. 28.1(2.1): "The administrator of a pension plan shall invest the assets of the pension fund, and manage those investments, in accordance with the regulations and in a manner that a reasonable and prudent person would apply in investing and managing a portfolio of investments of a pension fund."

²¹⁶ Committee on the Modernisation of the *Trustee Act*, "Trustee Investment Powers" (British Columbia: British Columbia Law Institute, April 1999) at 20.

fact that it is highly commercial. While in practice insurers are required to develop a SIPP-like document (there is some commentary similar to the regulatory guidelines on a pension plan SIPP that reflects a prudent portfolio approach), because there is less practical independence in the making of the investment, it is expected to mute the interest in ESG to some degree. Nonetheless, within existing parameters, just as in the discussion of pension plans, ESG is not prohibited per se.

3.3 Mutual funds

ESG considerations must be taken into account where so required by the trust deed and investment objectives. There are a relatively small number of ethical funds and these are clearly described as such and available to interested investors.²¹⁷

4 POTENTIAL LEGAL DEVELOPMENTS

4.1 General trends

Recently there has been pressure on some large pension plans and the CPPIB to take ESG considerations into account. Despite this pressure, no steps have been taken in this direction, as pension administrators and trustees appear to understand their fiduciary duty to act in the best interest of plan members to require them to focus on financial returns and, presumably, are fearful that doing otherwise may put them at risk of breaching these obligations.

4.2 Recent developments

Despite the above reservations, the growing number of grassroots organisations and other developments indicate a desire by certain stakeholders to apply ESG considerations. It is reasonable to expect that Canadian institutional investors will give increasingly greater prominence to ESG issues in the investment decision-making process.

In response to concerns surrounding apartheid in South Africa, the government of Ontario passed the South African Trust Investments Act in 1990 permitting trusts, registered charities and pension funds to dispose of and refuse to acquire South African investments (provided certain requirements on the consent of beneficiaries were satisfied) without breaching the trustee's statutory or other legal duties. This Act was repealed in 1997.²¹⁸

In autumn 2001, a Private Member's Bill was introduced in the House of Commons to amend the federal pension standards legislation to require a pension fund administrator 'to prepare a report setting out the social, ethical and environmental factors that have been considered, during the period, in the selection, retention and liquidation of investments under the administrator's responsibility and in the exercise of any rights related to those investments, including voting rights'.²¹⁹ The bill was not passed. In December 2001, the issue of ESG was again raised in the House of Commons during the Question Period.²²⁰

More recently, in February 2004, a motion was put forward in the House of Commons to the effect that the CPPIB should be guided by ethical investment policies to ensure that pension investments are socially responsible and do not support companies or enterprises that manufacture or trade in military weapons, have records of poor labour practices, or contribute to environmental degradation, or whose conduct, practices or activities are similarly contrary to Canadian values. The motion was not successful.²²¹

²¹⁷ For example, there are fund companies who specialize in ESG focused funds in the Canadian marketplace (e.g. Meritas and The Ethical Funds Company) as well as individual ESG focused funds offered by fund companies which do not provide such funds exclusively (e.g. Accuity Investment Management, Phillips Hager & North).

²¹⁸ *South African Trust Investments Act*, R.S.O. 1990, c. S. 16, as rep. by Statutes of Ontario, 1997, c. 23, s. 12.

²¹⁹ See Canada Bill C-394, An Act to amend the Pension Benefits Act, 1985 (investment criteria), 1st Sess., 37th Parl., 2001.

²²⁰ See House of Commons Debates, 132 (14 December 2001) at 1155 (Stephan Tremblay).

²²¹ See House of Commons Debates, 017 (2 February 2004) at 1020 (Pat Martin).

The increasingly frequent debates of the relevant issues and more recent and recurrent attempts at legislation facilitating ESG investment strategies indicate that there is considerable and persistent support for such measures. It remains to be seen how the issue will evolve over the next five to 10 years. However, if the level of support increases to the degree needed to implement a legislative solution, it will then be necessary to address the issue of the parameters of ESG investment, particularly in terms of values investment other than where a clear relationship can be shown between ESG and value.

1 INSTITUTIONAL INVESTMENT

1.1 Pension funds

The French pension system, a public system, does not feature pre-funded schemes (ie collective investment schemes specifically dedicated to pensions). The system, which varies across industries, features a mandatory pension plan and a complementary pension plan.

(a) Mandatory pension plans are divided into:

- a general old age insurance plan for private sector employees;
- a mandatory plan for public sector employees; and
- a mandatory plan for self-employed workers.

(b) Complementary pension plans are mandatory for all employees and optional for certain categories of independent workers (eg tradespeople, industrialists, independent professions). Mandatory complementary pension plans are managed by pension bodies, which are members of either AGIRC²²² or ARRCO.²²³

In 2001, reforms were introduced (the 2001 Law)²²⁴ giving the retirement reserve fund (FRR) a mandate to manage sums entrusted to it by public authorities until 2020 to buttress the basic pension scheme.

Individuals may supplement their pensions through an institute of forward planning – a private non-profit legal entity managed by its members. Pension savings can also be supplemented through private investments (eg PERP²²⁵).

1.2 Insurance companies

Insurance companies may adopt the legal form of a limited liability company or a mutual insurance company. Mutual insurance companies are non-profit legal entities.

1.3 Mutual funds

There are two forms of French collective investment scheme (OPCVM).

(a) An investment company with variable capital (SICAV) is a limited liability company that manages a portfolio of financial instruments and deposits. The SICAV may be self-managed or may delegate, in whole or in part, its management and the administration of its assets to a management company. As a company subject to the provisions of corporate law, a SICAV is managed in accordance with its by-laws, which contain general rules governing the company and the criteria determining its investment policy.

(b) A capital investment fund (FCP) is a co-ownership of financial instruments and deposits without any separate legal identity. The FCP is managed by a management company in accordance with the FCP's rules, which set out the criteria determining its investment policy. FCPs may take various forms depending on their investment profile and type of investors; these forms include the employee capital investment fund (FCPE) and venture capital investment fund (FCPR).

The assets of OPCVMs are held by separate custodians selected from a list provided by the minister of economy and finance. The custodian ensures that the decisions taken by the SICAV or the management company of the FCP comply with the relevant legal and regulatory provisions (as discussed below). It

²²² Association Générale des Institutions de Retraite des Cadres.

²²³ Association des Régimes de Retraite Complémentaires.

²²⁴ The law 2001-624 of 17 July 2001 amended by law 2003-775 of 21 August 2003.

²²⁵ Plan d'Épargne Retraite Populaire.

also ensures that such decisions comply with the investment rules set out in the by-laws/rules of the OPCVM.

The characteristics, investment rules and by-laws/rules of an OPCVM are set out in a detailed prospectus. This prospectus, which must be approved by the French financial market authority, is provided to each investor before subscription.

2 LEGAL CONTEXT FOR INVESTMENT DECISION-MAKING

2.1 Pension funds

The general legal framework

As there are no invested pension funds under French law, we have described below the legal context for investment decision-making of the FRR, which is the first institutional player to have officially launched in June 2005 a call for tenders to invest about €600m in an ESG-conscious manner.

Following a proposal from the executive board, the supervisory board of the FRR determines general guidelines on the investment policy of the FRR (please see section 3.1 below).

The 2001 Law, completed by the decree 2001-1214 of 19 December 2001 (the 2001 Decree), requires the FRR to invest in accordance with the following principles:

- the objective and timing (ie the year 2020) of the use of the FRR's assets;
- profitability (maximising investment returns);
- prudence; and
- adequate spread of risks.

Under the 2001 Law, the FRR must comply with prudential rules set out in the 2001 Decree on investment limitations and the types of assets in which investment is permitted.

The investment management of the FRR is delegated, in accordance with specific rules on calls for tenders contained in the French public procurement code, to investment firms licensed as portfolio management companies. Those investment firms (the Managers) are granted management mandates, which are periodically renewed.

The administrative management of the FRR is delegated to the Caisse des dépôts et consignations (CDC).

FRR's legal obligations

The executive board of the FRR must fulfil the following functions:

- implement the general guidelines on the investment policy defined by the supervisory board;
- prepare the specifications of calls for tenders;
- select the Managers;
- supervise the Managers' compliance with the FRR investment policy; and
- supervise the administrative management of the FRR.

The FRR is represented by the chairman of the executive board.

2.2 Insurance reserves

As a general principle, French insurance companies must maintain sufficient technical reserves to cover the aggregate of their liabilities. The technical reserves must be adequately calculated, accounted for, and invested in suitable assets, as provided in the French insurance code. This code contains a list of assets in which French insurance companies may invest. It sets out the diversification rules applicable to each category of eligible assets (eg an insurance company may not in principle invest more than 5 per cent of its eligible assets in securities of the same issuer). Insurance companies must also carry out an ongoing valuation of financial risk.

Insurance companies must maintain a solvency margin. They must detail information on this solvency margin in the annual solvency report prepared by their executive board or board of directors.

The board of directors or executive board is the representative, governing and managing body of the insurance company or mutual insurance company. The duties and responsibilities regarding decision-making of insurance companies are set out in the French code of commerce, whereas those relating to mutual insurance companies are set out in the French insurance code (regulatory section).

2.3 Mutual funds

In accordance with French legislation on OPCVMs, the management company and the custodian must offer sufficient guarantees regarding their organisation, their technical and financial means and the integrity and experience of their managers. The management company and the custodian are jointly or severally liable to the unitholders and to third parties for any breach of their legal obligations, of the OPCVM law or of the OPCVM's rules/by-laws.

The management company must act independently and in accordance with the following principles:

- perform its duties with loyalty, diligence, neutrality and impartiality in the exclusive interest of the investors and of the integrity, transparency and security of the market;
- take any appropriate arrangements to ensure the security of the transactions; and
- endeavour to prevent and resolve conflicts of interests.

The OPCVM's investment rules are subject to the following main principles:

- risk diversification (ie OPCVMs must comply at all times with legal ratios to limit the concentration of assets of the same nature in their portfolio or to limit the concentration of their risks and to diversify their investments);
- independence (ie investment by an OPCVM in units of another OPCVM is subject to a legal limit);
- valuation of their assets and calculation of the net asset value; and
- compliance with the investment policy as approved by the French Financial Market Authority (AMF) and communicated to unitholders.

3 INTEGRATION OF ESG CONSIDERATIONS INTO INVESTMENT DECISION-MAKING

3.1 Pension funds

According to its decision of 2 April 2003 on general guidelines regarding the investment policy of the FRR, the FRR's supervisory board has asked the executive board to 'actively contribute to promoting best practices', thereby encouraging Managers to incorporate values regarding balanced economic, social and environmental development into their analysis of financial assets and corporate governance transparency.

On this basis, the supervisory board and executive board have adopted a three-pronged strategy to promote ESG investment and best practice corporate governance.

- An active policy of proxy voting at shareholder meetings of corporations in which the FRR invests (via its Managers), in compliance with the relevant sections of the 2001 Decree. On 10 February 2005, the FRR published a set of broad proxy voting guidelines for Managers. Managers were selected in part on the basis of their capacity to fulfil this fiduciary duty across the board and in compliance with client guidelines. This active proxy voting policy has now been implemented.
- The enlargement of stock-research and picking criteria to include certain ESG considerations for Managers selected by the FRR to manage European equity mandates (totalling just over €3bn). The FRR asks that the Managers selected for these mandates commit themselves to:
 - conducting research and analysis, integrating relevant and reliable information on social and environmental behaviour and practices of companies being considered for investment and assessing their merits on the basis of the 10 principles of the UN Global Compact in particular;
 - endeavouring to include the findings of this research in their stock-picking process;

- promoting transparency and reporting on the way ESG criteria have been integrated and any problems encountered;
 - exchanging with the FRR in terms of method and research; and
 - developing ESG by managing several mandates dedicated to this approach to gain a better grasp of the characteristics of ESG-inclusive analysis that can be implemented in line with the FRR's philosophy and improve their ability over time to measure the value added of ESG processes in terms of investment performance.
- Creating a number of dedicated ESG mandates, with the aim of gaining a better grasp of the ESG-inclusive analysis that can be implemented and the value added by ESG factors. The call for tenders launched by the FRR on 28 June 2005 seeks to select Managers for these ESG mandates.

3.2 Insurance reserves

The French insurance code contains no legal provisions for, or explicit prohibitions against, taking account of ESG considerations. As long as the legal principles and legal obligations discussed above are duly complied with, ESG considerations may be taken into account.

3.3 Mutual funds

General provisions

Provided the principles and duties mentioned in section 2.3 above are complied with, there are no other specific provisions under French law restricting or encouraging investment by management companies on the basis of ESG considerations. Therefore, subject to OPCVM law, OPCVM investment policies may take ESG considerations into account on a voluntary basis.

Under article L. 214-39 of the French monetary and financial code, FCPEs deciding to take into account ESG considerations in their investment and voting policies must:

- state in their rules and prospectus (i) the precise criteria used to analyse ESG considerations and the methods employed to evaluate them; and (ii) whether their management company consults external specialised valuation agencies,²²⁶ and
- describe the implementation of the ESG considerations in their annual report.

In the absence of general legal provisions and a single definition of ESG considerations, the AMF recommends complying with transparency principles and providing investors with information on the:

- chosen definitions of sustainable development and ESG considerations;
- methods and processes used in the analysis, evaluation and supervision of ESG considerations implemented by management companies and external auditors;
- ethical rules that external auditors will apply to their valuation;
- impact of sustainable development strategies and ESG considerations on the income of the OPCVM; and
- impact of ESG considerations on the management of OPCVMs.

The Association Française de la Gestion Financière (AFG, the French asset management association, which represents investment funds and individual portfolio management) has drafted a set of transparency guidelines in this respect. OPCVMs that decide to comply with these guidelines on a voluntary basis must publish a list of answers to a set of questions supplied with the guidelines. These questions cover such issues as the general operation of the OPCVM, ESG considerations, research process, evaluation and implementation, engagement approach and voting policy.

Ethical funds

In addition to the general OPCVMs, there were over 120 French ethical OPCVMs in December 2004 and their number is increasing. They may take the form of solidarity funds, which finance solidarity economic projects, or sharing funds, which share a part of their income with charity organisations or NGOs.

²²⁶ Article 19 of instruction no. 2005-05 of the AMF.

(i) Solidarity funds

FCPEs subscribed to within the framework of a voluntary employee savings plan or a collective retirement savings plan may be categorised as solidarity funds. They invest 5 per cent to 10 per cent of their assets in, among others, shares or units issued by:

- companies licensed as solidarity companies ie promoting the integration of the unemployed or young people into the job market or the development of job creation activities with a social benefit, such as sporting, cultural, educational, environmental and community activities; or
- FCPRs investing more than 40 per cent of their assets in securities issued by such solidarity companies.

The wording *FCPE solidaire* must therefore be clearly indicated in the rules and the prospectus of the FCPE before or after its designation.

(ii) Sharing funds

Although there is no specific legal or regulatory provision defining the investment rules for sharing funds, they have been developed by managers as specific categories of OPCVMs investing in general in monetary or debt instruments (but not necessarily in solidarity companies). The unitholders/shareholders of a sharing fund agree to transfer part of their income to predetermined charity organisations or NGOs and benefit in return from tax advantages.

4 FUTURE DEVELOPMENTS

As noted above, there has been a marked increase in the number of ethical OPCVMs and the interest of institutional investors such as the FRR in ESG considerations – a trend that is likely to continue. In a recent press release, ARRCO and AGIRC indicated that they intend to launch a call for tenders to invest around €100m in developing strategies to integrate ESG considerations into investment decision-making.

5 SUMMARY

There are no general provisions under French law dealing with ESG considerations in investment decision-making. Investments by the FRR, OPCVMs and insurance companies taking into account ESG considerations are permitted (although not legally required) subject to compliance with the legal and regulatory provisions mentioned above.

1 INSTITUTIONAL INVESTMENT

1.1 Pension funds

An employer can use a pension fund – an independent legal entity – to arrange a company pension scheme in Germany.²²⁷ Pension funds can be organised as ‘mutual benefit societies’²²⁸ or as public limited companies.²²⁹ German pension fund managers can be described as external trustees.²³⁰ The main function performed by a German pension fund is managing company pension schemes for the employer²³¹ and thus each fund has to comply with capital investment obligations.

1.2 Insurance reserves

Two forms of private insurance under German law require funds to be raised and managed to meet liabilities: life insurance and private health insurance. In addition, reserves for private pension insurance²³² will probably become more significant in the near future as a result of demographic change.

1.3 Mutual funds

Mutual funds are defined as public funds managed by capital investment companies.²³³ The latter manage the funds for the benefit of the investors under the German Investment Act²³⁴ and in accordance with the contractual terms and conditions governing the legal relationship between the capital investment company and the investors.²³⁵

2 LEGAL CONTEXT FOR INVESTMENT DECISION-MAKING

2.1 Pension funds

If an employer decides to use a pension fund, it enters into a service agreement with that pension fund, and the fund becomes ultimately liable to the employee as a beneficiary. The responsibility for investment decision-making, therefore, is borne by the fund. The fund is not permitted to transfer the business risk to another legal person.²³⁶ Within the pension fund, the actuary bears the internal responsibility.²³⁷

German law contains detailed provisions concerning pension funds’ investment principles.²³⁸ Most importantly, pension funds must ensure that:

- the highest possible security and profitability are guaranteed;

²²⁷ See Sec. 112 Par. 1 of the German *Insurance Supervision Act* (Versicherungsaufsichtsgesetz, VAG).

²²⁸ *Versicherungsvereine auf Gegenseitigkeit*.

²²⁹ *Aktiengesellschaften*.

²³⁰ The German legal definition of a pension fund does not refer to the pension contribution plan, but rather to the company that manages the finances accumulated under the plan (ie the mutual benefit society or the public limited company): Cp. Prölss, VAG, § 112, recitals 12, 13; Engeländer/Slota, VW 2003, p. 243 et seqq.

²³¹ See Sec. 112 Par. 1 No. 1 VAG.

²³² *Riester-Rente*.

²³³ See Sec. 2 Par. 1 InvG.

²³⁴ December 2003, effective since 1 January 2004.

²³⁵ See Sec. 2 Par. 2 InvG.

²³⁶ Engeländer/Slota, VW 2003, p. 311 et seqq.

²³⁷ See Sec. 113, 11 a VAG.

²³⁸ See Sec. 115 Par. 1 VAG and the Pension Fund Investment decree-law (*Pensionsfonds-KapitalanlageVO, PFKapAV*).

- there is sufficient liquidity;
- an adequate spread of risks is guaranteed;²³⁹ and
- investments are managed professionally to guarantee compliance with investment principles.²⁴⁰

In addition, funds are expected to have adequate systems to control risk, efficient internal investment decision-making processes, a sound investment policy and appropriate organisational safeguards.²⁴¹

Finally, there is a detailed list of different forms of investments permitted for pension funds,²⁴² including, among other things, real estate, shares dealt with in a recognised market and loans granted to the Federal Republic of Germany or international organisations.

There is neither case law nor legislative guidance from the regulator²⁴³ to interpret these investment principles. The supervisory authority (the regulator) has, however, published non-binding interpretation rules for insurance company reserves²⁴⁴ (which are also obliged to guarantee that investments are as safe and profitable as possible). These rules can provide some guidance to pension funds by way of an analogy. As stated in the guidance, the regulator is above all concerned with the safety of investments. The term ‘profitability’ is interpreted to mean that an investment must have a sustainable profit. This, in turn, means that, on the one hand, neither a quantitative minimum return of investment is required nor a profit maximisation principle prescribed. On the other hand, it also means that unprofitable investments are not allowed. The term sustainable profit remains undefined.

2.2 Insurance reserves

Similarly to the provisions applicable to pension funds, German law contains detailed provisions concerning investment of insurance reserves.²⁴⁵ The principles resemble those for pension funds: namely, insurance companies must ensure the highest security and profitability of their investments. In addition, the liquidity of insurance companies and an adequate spread of risks (by diversification and a mixture of investments) must be safeguarded. These principles of investment are augmented by regulations specifying the permitted investment products. Insurance companies must comply with the principles of investment by engaging in professional investment management. This means making investment decisions in a professional manner – for example, implementing adequate risk management and internal control procedures.

In addition to the binding provisions discussed above, the regulator has published non-binding notes as mentioned above describing how it interprets relevant terms, especially the term ‘profitability’.

2.3 Mutual funds

A capital investment company must manage the funds with the care of a prudent businessman for the collective benefit of the investors.²⁴⁶ It must:

- act in the sole interest of the investors and the integrity of the market when performing its activities;
- perform its activities with due expertise, care and conscientiousness in the best interests of the funds managed by it and the integrity of the market; and

²³⁹ See Sec. 115 Par. 1 VAG.

²⁴⁰ See Sec. 1 Par. 2 PFKapAV.

²⁴¹ See Sec. 1 Par. 2 PFKapAV.

²⁴² See Sec. 2 PFKapAV.

²⁴³ *Bundesanstalt für Finanzdienstleistungsaufsicht*, responsible for the supervision of both pension funds and insurance companies.

²⁴⁴ Notes on the investment of fixed reserves of insurance companies, circular letter 29/2002 of 12 December 2002.

²⁴⁵ See Sec. 54 Par. 1, 66 Par. 1, 79 Par. 1 VAG.

²⁴⁶ See Sec. 9 Par. 1 InvG.

- endeavour to avoid and resolve conflicts of interest.²⁴⁷

Under the German Investment Act, the capital investment company is no longer obliged only ‘to act in the sole interest of its investors’ but is expected to ‘act in the sole interest of its investors and the integrity of the market’.²⁴⁸

3 INTEGRATION OF ESG CONSIDERATIONS INTO INVESTMENT DECISION-MAKING

3.1 Pension funds

There is neither a requirement for a pension fund to consider ESG issues in its decision-making process nor a prohibition against this. If, however, a pension fund decides to invest in ethical investment forms, it must inform the employees of this decision.²⁴⁹

The legislature expanded these disclosure obligations in the seventh amendment to the Insurance Supervision Act.²⁵⁰ This amendment goes beyond the disclosure requirements of the EU Occupational Pensions Directive, which it implements. Pension funds will soon be required to inform employees in writing of their ESG investment strategy when the pension is established. Subsequently, they must supply written information about ESG issues to the beneficiaries annually.²⁵¹ These provisions make it clear that a pension fund is expressly permitted to take account of ESG considerations. The principles of investment mentioned above will inevitably restrict the scope of such investments.²⁵² The guarantee of high security and profitability remains the primary objective. Therefore, investment is allowed only if this objective is achieved.

3.2 Insurance reserves

Similarly to the pension funds discussed above, the investment of private pension insurance reserves and life insurance reserves²⁵³ is governed by the obligations of disclosure to the policyholder; namely, the investing company must report whether, and to what extent, ESG considerations have been taken into account.²⁵⁴

The provider of private pension insurance, for example, has a duty to inform its contracting policyholders before the conclusion of the contract of whether, and to what extent, ESG factors are incorporated into decision-making.²⁵⁵ In addition, the issue must be tackled in the insurer’s annual report.²⁵⁶ According to a non-binding declaration by the regulator, given the complexity of the concept of ‘ethical investment’ the regulator will not object to the tackling of ESG issues in the annual report if this is carried out in a reasonable manner. This grants insurers a broad scope of discretion regarding the information requirements. Nevertheless, the general principles of investment must be adhered to and a permitted class of investments must be chosen.

For other forms of insurance neither the relevant legal provisions nor the guidance from the regulator prohibit or expressly permit ESG considerations to be taken into account. This seems to suggest that the consideration of these issues is permitted provided the general principles of investment are adhered to and only the permitted investment products are chosen. None the less, as discussed at 2.1 above,

²⁴⁷ See Sec. 9 Par. 2 InvG.

²⁴⁸ See Sec. 9 Par. 2 Nr. 1 InvG.

²⁴⁹ See Sec. 115 Par. 4 VAG.

²⁵⁰ BR – Drs 446/05 and BT – Drs 15/5221.

²⁵¹ See BR-Drs. 446/05.

²⁵² Cp. Prölss, VAG, § 115, recitals 45, 46.

²⁵³ But only in relation to company pension schemes.

²⁵⁴ See Sec. 10 Par. 1 a VAG; Sec. 7 Par. 1 No. 5 of the *Act on the certification of retirement arrangement contracts (Altersvorsorgeverträge-Zertifizierungsgesetz, AltZertG)*.

²⁵⁵ See Sec. 7 Par. 1, No 5 AltZertG.

²⁵⁶ See Sec. 7 Par. 4 AltZertG.

German law does set out an overarching principle of ‘profitability’. However, in view of the commentary provided by the regulator, we do not interpret this to mean that a quantitative minimum return of investment is required²⁵⁷ or that ESG considerations cannot be taken into account.

As a result, the insurers have a certain scope of discretion regarding ESG issues, as long as the formal requirements are fulfilled (eg permitted investment products are chosen) and the profitability of the investment decisions is at least ‘sustainable’.

3.3 Mutual funds

As mentioned above, capital investment companies’ duties with regard to investment decision-making are set out in the German Investment Act, which is silent on ESG issues.

In addition to statutory duties, a capital investment company must comply with the contractual terms and conditions determining the legal relationship between the capital investment company and the investors. The capital investment company is free to include ESG issues in the terms of the contract, as long as the scope of the mandate is sufficiently detailed. Given the requirement to provide in any contractual documentation an extensive description of tools and instruments that may be used in managing the fund, it is important that the right or obligation to consider ESG issues as part of investment decision-making is sufficiently prescriptive and specific. This applies not only to the terms of the contract documentation but also to sales prospectuses.²⁵⁸

If the mandate to address ESG issues is not included in the terms of the contract, the courts will not imply it retrospectively. The crucial question, then, focuses on what exactly is meant by the term ‘to act in the sole interest of the investors and the integrity of the market’.

The wording of ‘integrity of the market’ does not explicitly exclude social or environmental considerations. However, the legislator did not specifically refer to such an interpretation in the explanatory notes accompanying the German Investment Act. Rather, the notes specify that the phrase was intended to safeguard an orderly functioning of the capital market and prohibit price fixing. The overarching duty of an investment decision-maker in a capital investment company, therefore, is to realise the greatest possible return for the investor.

As a result, as things stand, a capital investment company will not comply with its code of conduct if an investment incorporating ESG issues is less profitable than the declined alternative. This is also the position of the regulator. The reference to the ‘integrity of the market’ potentially provides scope for a different interpretation of the legal framework governing investment decision making in the future as the public interest in environmental, social or corporate governance issues gains ground. However, at present the only way ESG issues can be integrated into investment decisions is if the contractual terms and conditions that determine the legal relationship between the capital investment company and the investor explicitly refer to them.

3.4 Shareholder activism

Shareholder activism on ESG issues is not widespread in Germany. As the German Federal Ministry for the Environment states in its publication on *Information on Environmental Investments*, funds or life insurance companies in particular do not make the most of the opportunities offered by their position as institutional shareholders.²⁵⁹ Thus, neither the big insurance companies nor the German insurance association and the large mutual funds provide any relevant guidance. This is the case only for ‘mainstream products’. Many funds specialised in ESG investment are trying to reach companies via shareholder activism. The same applies for ‘critical shareholders’: shareholder associations whose members belong to a major ecological group.

²⁵⁷ See Chapter A. II. a of the Notes on the investment of fixed reserves of insurance companies; cp. Pröls, VAG, § 54, recital 4.

²⁵⁸ See Sec. 42 No. 14 InvG.

²⁵⁹ Federal Ministry of Environment: Information on Environmental Investments (*Ökologische Geldanlagen*) p. 7, see (www.bmu.de/files/pdfs/allgemein/application/pdf/geldanlage.pdf).

4 SUMMARY

Under German law ESG issues have received legislative recognition only regarding pension funds and insurance reserves. Pension funds and insurance companies have a relatively free hand on these issues as long as they comply with the principle of the safest and most profitable investments. By contrast, written law is silent on ESG issues regarding mutual funds. Here, the investment decision maker has the duty to realise the greatest possible return for the investor. Therefore, the investment company is not allowed to take account of ESG issues unless they are included in the terms of the contract.

The above discussion should be viewed in the context of the German government's recently developed sustainability strategy.²⁶⁰ Here the government mentions, among other things, acceptance of global responsibility, environmental protection and promotion of innovative businesses as the main elements of sustainable development. Against this background, there is a clear discrepancy between the ambitions of the government's 'greening strategy' on the one hand and a very conservative legal framework governing investment behaviour (at least for mutual funds) on the other.

²⁶⁰ *Perspectives for Germany – our strategy for a sustainable development (Perspektiven für Deutschland – Unsere Strategie für eine nachhaltige Entwicklung)*, (www.bundesregierung.de/Anlage587387/pdf_datei.pdf)

1 INSTITUTIONAL INVESTMENT

1.1 Pension funds

Broadly speaking, there are three different forms of retirement schemes in Italy: (i) mandatory retirement schemes, (ii) complementary pension funds and (iii) supplementary pension funds. The pension funds under (ii) and (iii) are set up as segregated pools of assets and are managed by professional asset managers and insurance companies. Importantly, none of the schemes listed above operate by way of trusts, as this legal concept has limited relevance in the Italian legal system. Nonetheless, professional managers have duties similar to the fiduciary duties owed by a trustee.²⁶¹

1.2 Insurance reserves

Insurance companies are another important institutional investor in Italy with regard to the management of reserves. Such reserves may be managed by the insurance company itself; alternatively, they may be managed on behalf of the insurance company by fund managers. As indicated, professional managers have duties similar to the fiduciary duties owed by a trustee.

1.3 Mutual funds

Investment funds and self-managed investment companies (SICAVs) – equivalent to mutual funds – also play an important role in the Italian investment landscape. Again, professional managers have duties similar to the fiduciary duties owed by a trustee.

2 LEGAL CONTEXT FOR INVESTMENT DECISION-MAKING

2.1 Pension funds

As far as pension funds are concerned, managers are expected to comply with specific requirements with regard to investment limits and eligible assets²⁶² (as specified under the laws governing the setting up and management of pension funds and the implementing rules laid down by the pension funds regulator (COVIP)). Under article 1176 of the Italian civil code, in performing its obligations the obliged party is also expected to use the care of a ‘good father of a family’. Compliance with such duty of care is evaluated in light of the nature of the professional activity performed.

In addition, where the management of a pension fund is entrusted to a portfolio manager, the latter must fulfil the detailed requirements set out under the laws governing the provision of portfolio management services,²⁶³ particularly on dealings with customers. They are expected to:

- act honestly, fairly and professionally in accordance with the best interests of their customers and the integrity of the market (‘fair dealing’);
- disclose material interests;
- avoid conflicts of interest; and
- meet ‘know your customer’ requirements²⁶⁴ (ie conduct of business rules).

²⁶¹ Articles 21 and ff and 33 and ff of Legislative Decree no. 58 of 1998 and implementing regulations.

²⁶² Ministerial Decree no.703 of 1996, for example, requires fund managers to ensure that the funds are operated in such a way as to achieve diversification of investments, efficient portfolio management, maximisation of returns etc.

²⁶³ Managing portfolios of investments either on a discretionary client-by-client basis or on a pooled basis: article 1, paragraph 1, letter (n) and paragraph 5, letter (d) of Legislative Decree no. 58 of 1998.

²⁶⁴ Prior to providing any investment services to a customer for the first time and throughout the business relationship, the investment firm must seek to obtain from the customer information enabling it to determine whether the investment services envisaged are appropriate for the customer in light of his/her knowledge and experience in the investment field, investment objectives, risk profile, financial situation/capacity and any trading restrictions applicable to the customer.

The concept of fair dealing, importantly, includes acting in the best interest of customers, which, in turn, is interpreted as a duty to maximise profits deriving from investment activities.

2.2 Insurance reserves

The applicable laws²⁶⁵ governing the investment of insurance company reserves do not set forth specific principles constraining the discretion of the manager but only specify the types of eligible assets. The management of reserves must, however, be carried out in compliance with sound and prudent management criteria. In particular, in selecting investments, account must be taken of the need for safe investments, profitability, liquidity, and diversification and spreading of investments.

Where the management of reserves is entrusted to a portfolio manager, the latter must comply with the conduct of business rules applicable to the provision of portfolio management services as laid down in the relevant provisions of statute and implementing regulations described above. The key requirement on portfolio managers to act in clients' best interest to obtain the best possible results from the investments²⁶⁶ also requires the manager to efficiently manage risks and therefore appropriately diversify the investments, diversification being one of the main risk management tools.

Although there is no outright prohibition on taking account of ESG considerations and the duty of diversification might mean a broader portfolio could include, for example, green investments, the duty to act in the best interests of the client allows this only to the extent that the investment can maximise the financial return for the ultimate beneficiary.

2.3 Mutual funds

Under article 48 of Consob Regulation 11522 of 1998, as amended, asset management companies and SICAVs must:

- operate independently and according to the principles and general rules set forth under applicable laws;
- comply with the investment objectives set out in the prospectus of the collective investment scheme they manage – such objectives could include, for example, investment in environmentally sound companies only or exclude investment in tobacco or armaments producers;
- refrain from any conduct that might benefit one set of managed assets, including those managed in connection with the supply of portfolio management services on an individual basis, at the expense of another;
- acquire adequate knowledge of the financial instruments, goods and other valuables in which the assets under management may be invested – although this means they must weigh up all the relevant considerations before committing themselves to an investment, there is no guidance on the extent to which ESG considerations can form part of the decision-making process; and
- operate so as to minimise the costs borne by the collective investment scheme they manage and obtain the best possible results from the services performed, on the basis of the investment objectives of the collective investment scheme.

In summary, although there is no specific legislation or case law in Italy to prevent the integration of ESG issues into investment decision-making, the principle of maximising return for the beneficiaries prevails as the guiding principle for fund managers. On the other hand, if the objectives of the fund concerned state explicitly that ESG is to form part of the investment criteria, fund managers must take such issues into consideration.

²⁶⁵ Articles 26 of Legislative Decree 174 of 1995 (life insurance law) and article 27 of Legislative Decree 175 of 1995 (non-life insurance law).

²⁶⁶ Article 26 of Consob Regulation no. 11522 of 1998, as amended, implementing the provisions of articles 21 and ff of Legislative Decree no. 58 of 1998.

3 INTEGRATION OF ESG CONSIDERATIONS INTO INVESTMENT DECISION-MAKING

At present, the legal and regulatory framework offers little guidance on the validity of integrating ESG issues into investment decisions. The only initiatives in this respect have so far been autonomous initiatives by managers and self-regulating organisations. However, there have been a number of positive developments in this field:

Investment funds classified by the Italian asset management association as ethical funds and characterised by their specific investment policies are gaining momentum as vehicles for responsible investment. These funds prioritise social, ethical and/or environmental considerations above maximising financial returns.

It is worth noting that the Italian bankers association, the insurance companies association and asset management companies association form part of the Forum per la Finanza Sostenibile, the Italian sub-forum belonging to Eurosif. The association is committed to providing input and guidance to associated firms to promote a socially responsible investment culture. Therefore, at least at a voluntary level, there is growing support for integrating ESG issues into the investment decision-making process.

Passive screening is gaining popularity: Italian pension funds are increasingly including in asset management agreements concluded with portfolio managers an obligation on the part of the managers to invest in securities issued by companies included in the various indexes of socially responsible companies (eg Ethical Index Euro, Ethical Index Global and Ethical Sustainability Index).

4 FUTURE DEVELOPMENTS

The Italian parliament has recently delegated the function of reforming the Italian retirement system to the Italian government.²⁶⁷ The government will be expected to carry out the reforms within the framework of principles and criteria laid down by the parliament.

In so doing, the parliament has acknowledged the indications set out in the Green Paper *Promoting a European framework for Corporate Social Responsibility* of the European Commission (COM(2001) 366, July 2001). The new rules governing the Italian retirement system will require pension funds to indicate in their annual accounts and in the communications addressed to the participants if, and to what extent, priority is given to social, ethical and/or environmental considerations in (i) managing the assets deriving from subscribers' contributions and (ii) exercising shareholders' rights. The implementing legislation is yet to be introduced.

In addition, Italy is currently implementing the European Occupational Pensions Directive.²⁶⁸ The draft decree does not specifically refer to investment policies, but envisages the government issuing rules 'in accordance with the principles laid down in the Directive.'

²⁶⁷ Law no. 243 of 23 August 2004, published on the official Journal no. 222 of 21 September 2004 - 'Rules on pension schemes and delegation of the legislative function in the field of public pensions to the government with a view to supporting supplementary pensions and stable employment and with a view to reorganising agencies managing the mandatory pensions and welfare systems'.

²⁶⁸ A legislative decree for an amendment (draft bill no. 3509 of 21 June 2005) to the Community Law (which delegates the function of implementing EU legislation to the Italian government) with a view to implementing the Occupational Pensions Directive is currently pending.

1 INSTITUTIONAL INVESTMENT

1.1 Pension funds

The Japanese pension system is three-tiered. The first two tiers are made up of public pensions, namely the National Pension, a basic pension provided by the state, and Welfare Pension Insurance, which employees of private companies must register for. The National Pension is funded from government revenue rather than via investment. The funds for the Welfare Pension Insurance scheme are invested and managed by the Government Pension Investment Fund (GPIF).

The third tier consists of pensions set up by private corporations. Corporate pensions take a variety of forms, but are typically funded from investments managed by an independent manager or trustee. One key corporate pension is the employees' pension fund (EPF), a legal entity that provides part of the old age pensions under the Welfare Pension Insurance in place of the government, in addition to certain other benefits. A company's employees automatically become fund members of the EPF. The EPF is allowed to manage the fund assets itself, but normally this function is delegated to trust companies and/or life insurance companies because of a lack of in-house capacity.

Other types of corporate pension include:

- the mutual aid system for small and medium-sized businesses (MSMB);²⁶⁹
- tax-qualified pension plans (TQPP);²⁷⁰
- defined-benefit plans (DB);²⁷¹ and
- defined-contribution plans (DC).²⁷²

1.2 Insurance reserves

Insurance companies must²⁷³ keep money received from policyholders where the amount of the insurance payment under the policy is not guaranteed or fixed (floating insurance) in a specific account for each of the policyholders.²⁷⁴

²⁶⁹ MSMBs can be established by contracting with the mutual aid organisation for employees' retirement allowances, which is a government-affiliated corporation. The organisation administers asset management, generally by contracting with trustee companies and/or life insurance companies.

²⁷⁰ A TQPP is a pension plan established under the Corporate Tax Law (Law No 34 of 1965, as amended). This pension plan is established by a contract between the employer and the trustee companies and enjoys certain tax benefits. It is expected to be abolished in the near future as part of restructuring of the Japanese pension system.

²⁷¹ The Defined Benefit Corporate Pension Law (DB law) became effective on 1 April 2002 and provides two types of defined-benefit pension plan: contract type and fund type. The contract type is similar to the TQPP discussed above. An employer establishes a DB of this type by contracting with a trustee company. The fund type is similar to the EPF. An employer with more than 300 employees can establish a DB fund, which is usually managed by an external trustee company.

²⁷² The Defined Contribution Pension Law (DC law) became effective on 1 October 2001. A DC created under this law has many similar features to a US-style 401(k) plan. Whereas the DB fund mentioned above is usually run by an employer and its rate of return is generally guaranteed by the employer, the benefits that employees will receive in the future under a DC plan will vary according to the performance of the underlying investments, while the contribution is defined. Employees will be responsible for selecting their own investments or categories of investments. Under the DC law, two types of plans are offered: a corporate plan and an individual plan. Under the corporate plan, the employer will contract with the trustee companies that administer the asset management under instructions from the employees. The individual plan is for self-employed workers and other employees who cannot receive employer contributions towards corporate pensions. Under the corporate plan, the employer is expected to ensure that the employees are familiar with the plan and principles of investment.

²⁷³ Article 118 of the Insurance Business Law (Law No 105 of 1995, as amended) and article 74 of the implementing regulations of the Insurance Business Law (reg. No 5 of the Ministry of Finance, dated 29 February 1996).

Insurance companies sell a wide variety of floating insurance products, such as policies under which the policyholder will receive floating payments calculated at the end of the insurance period based on the value of investments managed by the insurance company if he/she survives the insurance period. The Insurance Business Law and other regulations provide special requirements for floating insurance, such as segregation of the assets and disclosure requirements for customers.

1.3 Mutual funds

The Law Concerning Investment Trusts and Investment Corporations²⁷⁵ regulates those types of investment funds. Under an investment trust, investors and a trustee enter into a trust agreement, or the settler of the trust sells its beneficial interests to investors. Investment corporations are schemes in which investors are members of the corporation that contracts with an investment manager who administers the invested funds.

Under the Law for Regulating Securities Investment Advisory Business,²⁷⁶ registered investment advisers are allowed to have a discretionary investment advisory agreement with investors. Under this agreement, the discretionary powers necessary to make investment decisions and to place transaction orders on behalf of the investors are entrusted to investment advisers.

2 LEGAL CONTEXT FOR INVESTMENT DECISION-MAKING

2.1 General duties

Given that Japan is a civil law country, the general duties of persons that manage the business or property of others are set out in the civil code. Article 644 of the civil code requires such persons to apply a duty of care that is similar to the ‘prudent person’ rule in other jurisdictions. Under this article, a person who is under a duty to manage another person’s business or property under an agreement must perform their duties with the reasonable care of a ‘hypothetical good manager’. In the judgment of Nagoya district court dated 20 January 1997 it was held that the behaviour of a director of a bank would be judged against a standard of an ‘ordinary corporate person’, paying particular attention to the facts that formed the basis of his/her decision, and the decision-making process itself, to establish whether the director concerned had violated the discretionary powers entrusted to him.

Trustees are also subject to specific duties under the principles of trust law that govern all trusts.²⁷⁷ Article 20 stipulates that trustees must administer the trust business with the reasonable care of a hypothetical good manager and also that they must act according to the purpose of the trust. Article 22 prohibits trustees from dealing unlawfully with the trust’s assets. Trust law is generally interpreted as establishing a ‘duty of loyalty’, whereby trustees are expected to perform their duties in good faith on behalf of the beneficiaries and to avoid conflicts of interest.

The relationship between the duty of care and duty of loyalty under Japanese law remains unclear, as can be seen in a well-known case dated 24 June 1970.²⁷⁸ The supreme court held that ‘the duty of loyalty’²⁷⁹ is not separate from the duty of care. Rather, it represents one substantive element of the duty of care as formulated by the courts.

²⁷⁴ By contrast, insurance companies are allowed to mingle their own money together with money received from holders of a policy in which the amount of the insurance is guaranteed or fixed.

²⁷⁵ Law No 198 of 1951, as amended.

²⁷⁶ Law No 74 of 1986, as amended.

²⁷⁷ Under Japanese law, trust is settled by contract. ‘Trust law’, therefore, refers to principles implied in the general provisions of the Civil Code.

²⁷⁸ Minshu 24.6.625.

²⁷⁹ In this case, the duty of loyalty concerned the duty of company directors under article 254-3 of the Commercial Code, which stipulates that a director is obliged to comply with all relevant laws, regulations, articles of association, as well as all resolutions adopted at a shareholders’ meeting and is expected to perform his duties faithfully on behalf of the company.

Given that the duties of care and loyalty apply to most institutional investors²⁸⁰, and given that the relationship between those duties remains unclear, a number of investor-specific laws have been issued to clarify the obligations of trustees/managers in each type of fund.

2.2 Pension funds

In addition to the general duties of care and loyalty, each type of investor will also be subject to a specific set of principles applicable to its decision-making process.

Public pensions

The Government Pension Investment Fund Law²⁸¹ stipulates that administrators of the GPIF must perform their duties in good faith on behalf of the fund. The ministry of health, labour, and welfare (MHLW) has broad-ranging powers to supervise the business of the GPIF, which includes the establishment of the investment principles for the fund.²⁸²

Corporate pensions

(i) EPF: the employees' pension law²⁸³ requires the administrators of the EPF to perform their duties in good faith on behalf of the fund. The EPF must manage its funds in a prudent and effective manner,²⁸⁴ and owes a duty of care under the civil code to the employer who established the EPF. Although the duties owed to beneficiaries/employees are not specified, it is generally understood that general duties of care and loyalty are owed to beneficiaries/employees in the same way as they are owed to the employer.²⁸⁵ It is generally understood that fiduciaries must maximise financial return for the beneficiaries;²⁸⁶ the duty of loyalty has been interpreted by the Pension Fund Association (a non-government association of EPFs²⁸⁷) to mean that investment activities ought to be performed in a 'safe and effective way' to protect the beneficiaries' right to receive benefits. Managers' performance will be assessed against 'generally accepted practices' and by looking at risks and returns over the portfolio as a whole.²⁸⁸

(ii) MSMB: the administrators of the organisation set up under the MSMB are required to perform their duties faithfully on behalf of the organisation.²⁸⁹ It is also generally understood that they must seek to maximise the financial return for beneficiaries.

(iii) TQPP: there are no special provisions applicable to TQPPs, although the general duties under trust law will be of direct relevance to the TQPP trustees. It is also generally understood that a trustee of the TQPP, as a fiduciary, must maximise financial returns for the beneficiaries.

(iv) DB: under the DB law, the employer, the administrators of the DB fund, as well as any trustee who contracts with the employer or the DB fund, are obliged to perform their duties in good faith on behalf of the beneficiaries. Again, it is understood that, in their position as fiduciaries, they owe the beneficiaries a duty to maximise return on their investments.

²⁸⁰ Article 28, s.1 and 2 of the Trust Business Law (Law no. 154 of 2004).

²⁸¹ Article 21, s.3. of the Government Pension Investment Fund Law (Law No 19 of 2000, as amended).

²⁸² Article 79-4 of the Employees' Pension Law (Law No 115 of 1954, as amended).

²⁸³ Article 120-2 ante.

²⁸⁴ Article 136-3, s 5 ante.

²⁸⁵ See the public report issued by the fiduciary duty study group of the Pension Fund Association, www.pfa.or.jp/.

²⁸⁶ These fiduciary duties tend to be propounded by the trustees/managers themselves to protect their legal position.

²⁸⁷ The functions of the Pension Fund Association include supporting and advising on the EPF's business, holding study groups, guaranteeing payments by EPFs and managing/investing its own fund to meet its guarantee obligations.

²⁸⁸ *Pension fund association fiduciary duties handbook*, 2005.

²⁸⁹ Article 63 of the mutual aid law for the retirement allowance of small and medium-sized business.

(v) DC: under the DC law, the employer and the trustee who contracts with the employer must perform their duties in good faith on behalf of the beneficiaries. It is also agreed that the trustee who contracts with the employer or individuals, as a fiduciary, must maximise financial return for beneficiaries.

2.3 Insurance reserves

There are no special provisions for insurance companies with regard to the management of floating insurance accounts. Since insurance is a contractual agreement, insurance companies owe a duty of care to the policyholders under the general laws of contract.

2.4 Mutual funds

Under the law concerning investment trusts and investment corporations, the trustees of any investment trust and any investment managers who contract with them must administer the funds in good faith and administer the trust business with the reasonable care of a hypothetical good manager.

Investment advisers are obliged to perform their duties under the discretionary investment advisory agreement in good faith on behalf of the customers.²⁹⁰

3 INTEGRATION OF ESG CONSIDERATIONS INTO INVESTMENT DECISION-MAKING

3.1 Pension funds

Public pensions

There are no legal rules or official guidance prescribing or encouraging the integration of ESG issues into investment decisions with respect to public pensions.

As described above, the administrators of the GPIF owe a duty of loyalty to the fund and not directly to the beneficiaries. Furthermore, it is difficult to establish a duty of care of the GPIF under the civil code or the trust law because there is no contract or a similar relationship between the fund and the beneficiaries.²⁹¹

However, the fund and its administrators must act according to the investment principles established by MHLW. Consequently, it will be a matter of MHLW guidance to establish whether ESG issues can be incorporated into investment decision-making. Because the investment decisions of the fund are carried out on behalf of the government, and because of the significant impact those decisions may potentially have on the market (due to the size of the fund), MHLW's current investment principles prohibit the GPIF from selecting equities (rather, it must invest in general funds like the Nikkei 100). The principles also forbid the fund from exercising shareholder activism in companies included in its investment portfolio.

Corporate pensions

(i) EPF: the Pension Fund Association announced its standards on shareholder activism on 20 February 2003. The standards stipulate that the Pension Fund Association should encourage companies to fulfil their social responsibilities, including improving their relationships with customers, employees and the wider community, as well as their environmental impact. The standards have significant persuasive authority on EPFs' businesses, but are not binding. However, it is generally understood that corporate governance offers a valuable tool for retaining corporate value, and that social, ethical and/or environmental considerations are an integral part of corporate governance. Therefore, as long as the consideration of corporate governance is consistent with the purpose of retaining or increasing corporate value, we believe that EPFs and their administrators are allowed to integrate ESG issues into their decision-making in order to protect the value of the funds.²⁹²

²⁹⁰ Law No 198 of 1951, as amended.

²⁹¹ Administrators owe a duty of care to the government under the GPIF. We cannot find any authorised materials discussing this issue.

²⁹² The standards of the Pension Fund Association also state that companies represent vehicles for generating profits, and continuous prosperity of companies is vital for the safe management of the pensions system.

On the other hand, as far as screening of investments is concerned, there are no legal requirements or official recommendations relating to the consideration of ESG issues in EPF investment portfolios. On the contrary, it has been suggested that since EPFs and EPF administrators owe a duty to maximise financial benefits for beneficiaries, taking account of ESG issues when constructing the investment portfolio would conflict with the fiduciary duty unless it can be shown that doing so offers greater financial return for the beneficiaries.²⁹³

Ultimately, however, Pension Fund Association guidance suggests that investment decision-makers will be judged on whether they have properly identified and weighed up the relevant alternatives and reached a reasonable decision, rather than on the performance of their investments judged with the benefit of hindsight.²⁹⁴ It is also worth noting that the Pension Fund Association guidance suggests that in devoting themselves to the beneficiaries' interests, decision-makers 'shall be required to make decisions...in the interests of beneficiaries as the primary motive or purpose' but that permitting other interests to have an impact 'incidentally or consequentially...shall not be an immediate breach of the duty'.²⁹⁵

(ii) MSMB: the discussion on EPF above applies also to MSMB pensions.

(iii) TQPP: TQPP's investment policy is generally defined by the trust agreement between the trustee and the employer. However, the beneficiaries in a TQPP scheme are employees, and, as discussed above, the trustee of TQPP, in its role as a fiduciary, has to maximise the financial return for the beneficiaries. We believe, therefore, that the discussion on EPF above generally also applies to TQPP. Consequently, the trustee of the TQPP is allowed to take account of ESG in its role as a shareholder, but not when constructing the fund's portfolio, unless it can be clearly shown that such consideration is in the best financial interests of the beneficiaries.

(iv) DB: see the discussion on TQPP above.

(v) DC: under DC law, each employee (effectively, the beneficiary) is responsible for a share of the investment decision-making. Consequently, the principles applicable to their investment decisions will be analogous to those applicable to mutual funds (see below).

3.2 Insurance reserves

Investment policies relating to the floating insurance accounts managed by insurance companies are defined and agreed in consultation with the policyholders. Insurance companies are, therefore, allowed to take account of ESG considerations when acting as shareholders of the companies included in their investment portfolio as well as when screening investments, as long as the beneficiaries have expressed their consent. However, in practice very few insurance companies take environmental considerations into account either when constructing their portfolios or when acting as shareholders.

3.3 Mutual funds

Mutual funds' investment policy is defined and agreed upon by its investors.²⁹⁶ Trustees/managers of mutual funds are, therefore, allowed to take account of ESG considerations when they act as

Given that long-term stability of corporate profit is the only means of ensuring a financial return for the beneficiaries, the importance of corporate governance cannot be underestimated.

²⁹³ The investment principles announced by the Pension Fund Association state that any pensions investment manager ought to aim to achieve a result that exceeds market rate of return. They do not refer to the consideration of ESG.

²⁹⁴ The Pension Fund Association handbook suggests that the duty to 'devote themselves to the consideration of the interests of beneficiaries' imposes a duty to make 'appropriate decisions, including selection of alternatives for comparison, and proper deliberation of such alternatives.' The association notes that 'advice from external professionals may be beneficial.'

²⁹⁵ *Pension fund association handbook*, op cit.

²⁹⁶ Generally, mutual fund structures a product, accompanied by an investment policy, and offers the product to investors. While the type of agreement varies, the investment policy is deemed agreed between the mutual fund and the investor when the investor purchases the relevant product.

shareholders of the companies included in their investment portfolio as well as while screening investments, as long as beneficiaries give their consent. In fact, a number of mutual funds already take environmental considerations into account when constructing their portfolios.²⁹⁷

4 FUTURE DEVELOPMENTS

One of the problems hampering the integration of ESG into investment decisions in Japan is the sheer complexity and vagueness of laws and regulations described above. The government is discussing and planning to amend the trust law and planning to enact an Investment Service Law that would establish a consistent fiduciary duties regime applicable to all parties involved in the pensions market. It is expected that this proposed legislation would clarify the scope and applicability of fiduciary duties. However, ESG issues do not form part of the proposed amendment to the Trust Law and the new Investment Service Law. On the market-research side, substantial practical surveys examining the correlation between ESG and profitability are anticipated. Arguably, if a positive correlation were established, it would become more appropriate to consider ESG issues when constructing the portfolio.

5 SUMMARY

As noted, investment companies that manage mutual funds have already introduced various financial products in which ESG issues are taken into account into the market. It seems that ESG is one of the selling points of such products, and the existence of these products is recognised not only by institutional investors, but also retail investors.

However, from a legal point of view, we think that the discussion with regard to ESG is still in its early stages in Japan. The principle of profit maximisation remains engrained within the investment market's regulatory framework, and any screening of investments or shareholder activism must be carried out in keeping with the principles of maximising the financial return for the beneficiary.

One of the reasons would be the passive attitude of the GPIF and EPFs. They have experienced severe financial difficulties since the collapse of the economic bubble and, therefore, have had to concentrate on maximising financial value rather than social responsibility. The ministry of environment published the *Report of the surveillance study concerning environment-conscious activities in financial business* in March 2002. It stated that the impetus to take environment-conscious activities has been weak in the financial industry in Japan as compared to in the US and Europe, and that wider discussion is necessary throughout society if promotion of the environment and social fairness are to become more established in the financial industry. The report describes ESG-related efforts made by private mutual funds only, and makes no mention of pension funds or insurance companies.

²⁹⁷ Note, for example, the Nikko Eco-fund (www.nikko-am.co.jp/fundinfo/252263/) sold by Nikko Asset Management.

1 INSTITUTIONAL INVESTMENT

1.1 Pension funds

A pension fund is managed and administrated by a Spanish management company (the Pension Manager) and by a Spanish custodian entity (the Custodian) under the supervision of a controlling body (the Control Commission). Its administration does not follow the Anglo-Saxon equivalent of a trust, as the Control Commission is legally formed as an administration body that controls and supervises the activities of both the Pension Manager and the Custodian.

Pension Managers are limited liability companies²⁹⁸ whose sole corporate purpose is the administration and representation of pension funds. The Custodian, on the other hand, is a Spanish depository entity that exercises custodial and depository functions over the securities and finance assets of the pension fund, supervises the activities of the pension manager, and purchases securities on behalf of the pension fund.

The incorporation deed of the pension fund contains its performance rules, which specify the policy for investing the fund's assets, including details of risk-weighting and risk-control procedures and the investment strategy to be adopted. In addition, the Control Commission, with the participation of the Pension Manager, will issue a written statement with the principles of its investment policy for every pension fund.

The Pension Manager may give the mandate for the management of certain types of financial assets (as specified in the Spanish legislation on pension funds) to authorised third parties. The terms of any such contractual agreement are prescribed by the specific Spanish legislation on pension funds. It should be noted that the responsibilities and obligations of the Pension Manager and the Custodian will not be affected by the fact that they have delegated, respectively, the management and custody of financial assets to a third party.

1.2 Insurance reserves

Insurance companies may adopt the legal form of a limited liability company (*sociedad anónima*), mutual society (*mutua*), a co-operative association (*cooperativa*) or mutual fund (*mutualidad de previsión social*). Insurance companies are self-managed entities (although they may enter into management agreements with third parties for the investment of their reserves).²⁹⁹

1.3 Mutual funds

There are two legal forms of collective investment schemes under Spanish law:

Investment funds

Investment funds are funds without a separate legal status that are owned by the various investors and are managed and administered by a Spanish collective investment scheme management company (SGIIC)³⁰⁰ and a custodian entity. SGIIC manages the funds without having their legal ownership. The exclusive purposes of an investment fund, therefore, are to manage the pooled assets and invest them in goods, rights and securities or other instruments with the view to delivering a return to the unit-holders/shareholders (as judged by the aggregate results of the portfolio as a whole).

Investment funds are managed subject to the deed of incorporation and management regulations, which contain investment criteria and the rules for the selection of securities that form part of the investment fund's portfolio.

²⁹⁸ *Sociedades anónimas.*

²⁹⁹ *Provisiones técnicas.*

³⁰⁰ *'Sociedad Gestora de Instituciones de Inversión Colectiva'.*

In addition, the management company must make available to the unit holders/shareholders and to the public at large a range of prospectuses and performance reports. The prospectuses may specify the extent to which environmental, social or corporate governance considerations may or must be taken into account (see below).

Investment companies

Investment companies are limited liability companies with a separate legal status, which are set up for the same purpose as investment funds. Investment companies may be self-managed or may appoint an authorised third party to manage and administer the assets on their behalf.

Investment companies are managed according to their deed of incorporation and their own bylaws. The bylaws contain the criteria and general rules that each investment company must comply with when determining its investment policy. In addition, if provided in their bylaws, investment companies may delegate (in whole or in part) the management of their assets to third parties. Again, this delegation will not exonerate the members of the board of directors from the obligations and responsibilities they owe to the ultimate beneficiaries. The disclosure obligations applicable to investment companies are similar to those applicable to investment funds.

2 LEGAL CONTEXT FOR INVESTMENT DECISION-MAKING

2.1 Pension funds

The general legal framework

Spanish law requires Spanish pension funds to invest subject to the following principles:

- capacity to meet forecasted/potential financial liabilities;
- profitability;
- dispersion; and
- diversification.

In addition, Spanish pension funds are expected to comply with the investment restrictions (which may be further enhanced by the fund's internal investment performance rules) set out in legislation.³⁰¹ The legislation requires that assets be invested in the interests of participants and beneficiaries and, in the case of a conflict of interests, priority be given to the protection of the participants and beneficiaries. The Spanish legislation on pension funds specifies the types of assets in which investment is permitted.³⁰²

Investment of pension funds must at any time be sufficiently diversified in a way which prevents excessive dependence on one investment, one single issuer or group of companies or accumulation of risk in the aggregate portfolio.

Spanish legislation and case law are silent as to whether 'interests' means financial interests. Nor do the relevant legal sources specify that pensions managers and custodians must act in the 'best' interests of the participants and beneficiaries – rather, there is an obligation to simply act in the interests of the pension funds. However, given that one of the principles that should be taken into account is profitability (although, again, the law does not specify whether 'maximum profitability' is required), it would appear that ESG considerations can be included as long as the principles set out above are met.

³⁰¹ Legislative Royal Decree 1/2002, of 29 November, by which the law on pension plans and funds was approved (*Real Decreto Legislativo 1/2002, de 29 de noviembre, por el que se aprueba el texto refundido de la ley de regulación de los planes y fondos de pensiones*) and Royal Decree 304/2004, of 20 February, by which the regulations on pension plans and funds were approved (*Real Decreto 304/2004, de 20 de febrero, por el que se aprueba el reglamento de planes y fondos de pensiones*).

³⁰² A broad range of investments is permitted, including securities listed in securities markets, deposits, certain real estate, mortgages and derivatives.

Legal obligations

Although, as has been stated above, pension funds do not operate by way of trusts, and therefore the concept of fiduciary duties does not have direct application under Spanish law, the legal obligations of the various parties involved in the management of pension funds closely resemble the fiduciary duties under the Anglo-Saxon model.

The pension fund's Control Commission must fulfil the following functions:³⁰³

- supervise the implementation of the pension fund's performance rules (which includes the pension fund's investment policy);
- appoint the expertise required under Spanish legislation on pension funds; and
- represent the pension fund (although this function may be delegated to the Pension Manager).

Pension Managers and Custodians, moreover, must act in the interests of the fund they administer, and are therefore liable against the promoting entity³⁰⁴ and the beneficiaries for all damage caused as a result of a breach of their respective obligations. Their conduct will be judged against standards of reasonable care in the particular circumstances and investment decisions will not be assessed with the benefit of hindsight. In case of conflict of interests, priority must be given to protecting the interests of participants and beneficiaries.

'Reputable'³⁰⁵ individuals with adequate qualifications and professional experience must manage the pension fund's investments.

2.2 Insurance reserves

The general legal framework

A Spanish insurer is obliged to maintain sufficient reserves – literally, 'technical provisions' (*provisiones técnicas*, or PTs) – to cover the aggregate of its liabilities. For such purposes, the PTs must be adequately calculated, accounted for, and invested in suitable assets, as provided in the Spanish insurance legislation.³⁰⁶ The amounts of the PTs must ensure the punctual fulfilment of the insurer's obligations and must be made according to principles of congruence, profitability, safety, liquidity and diversification of investments, while bearing in mind the financial obligations assumed by the insurer.

Legal obligations

The board of directors is the representative, governing and managing body of an insurance company,³⁰⁷ and the provisions of the Spanish Limited Liability Companies Act³⁰⁸ will apply to its activities and decision-making. Members of a board of directors of a Spanish limited liability company have the following duties:³⁰⁹

³⁰³ Legislative Royal Decree 1/2002, of 29 November, by which the law on pensions plans and funds was approved (*Real Decreto Legislativo 1/2002, de 29 de noviembre, por el que se aprueba el texto refundido de la ley de regulación de los planes y fondos de pensiones*) and Royal Decree 304/2004, of 20 February, by which the regulations on pension plans and funds were approved (*Real Decreto 304/2004, de 20 de febrero, por el que se aprueba el reglamento de planes y fondos de pensiones*).

³⁰⁴ The entity that promotes the incorporation (or participates on the development) of a pension plan.

³⁰⁵ 'Honorables'.

³⁰⁶ Primarily, Legislative Royal Decree 6/2004 (*Real Decreto Legislativo 6/2004, de 29 de octubre, por el que se aprueba el texto refundido de la ley de ordenación y supervisión de los seguros privados*) and Royal Decree 2486 /1998 (*Real Decreto 2486/1998, de 20 de noviembre, por el que se aprueba el Reglamento de Ordenación y Supervisión de los Seguros Privados*). A broad range of assets is permitted.

³⁰⁷ Note that this applies to those insurance companies that have the legal status of '*sociedad anónima*' or '*mutua*'. For insurance companies arranged as '*cooperativa*', the *Consejo Rector* will perform functions equivalent to those performed by a board of directors.

³⁰⁸ Real Decreto Legislativo 1564/1989, de 22 de diciembre, por el que se aprueba el texto refundido de la ley de sociedades anónimas (the Limited Liability Companies Act).

³⁰⁹ This section will also apply to members of the board of directors of SGIIC, investment companies and Pension Managers.

- the duty to act with the diligence of an ‘orderly’ businessman and of a loyal representative;
- duty of fidelity: directors must fulfil the duties imposed on them by law and by the bylaws to act in the interests of the company (as opposed to the company’s shareholders’ individual interests); and
- duty of loyalty: directors’ duty of loyalty is aimed at avoiding conflict of interests between directors and the company and also at preventing directors from carrying out unauthorised competing activities.

2.3 Collective investment schemes

The general legal framework

Under Spanish legislation on collective investment schemes,³¹⁰ assets must be invested according to the following principles:

- liquidity;
- risk diversification (ie, the scheme is expected to limit the concentration of risk by diversifying its investments); and
- a clear definition of the company’s investment profile, which must be adequately reflected in the relevant documentation.

In addition, investments must be made in the assets permitted by the Spanish legislation governing collective investment schemes.

Legal obligations

Under the Spanish legislation on collective investment schemes:³¹¹

- the SGIIC functions must be undertaken with the diligence of an ‘orderly’ businessman and of a loyal representative;
- an SGIIC must act for the benefit of the unit holders and shareholders whose assets they manage (as for the meaning of ‘benefit’, and the implications it has on ESG issues, please see the discussion of pension funds’ legal obligation to act in the ‘interests’ of beneficiaries above);
- an SGIIC will be liable to the unit holders/shareholders for all damage caused to them as a result of a breach of SGIIC’s legal obligations; and
- the SGIIC is also obliged to require the custodian to assume liability for its actions carried out on behalf of the unit holders/shareholders (and the custodian is obliged to require the same from the SGIIC).

Under the Spanish legislation on collective investment schemes, the functions to be performed by a custodian must be undertaken with the diligence of an ‘orderly’ businessman and of a loyal representative. The custodian will also be liable to the unit-holders/shareholders for all damage caused to them because of a breach of its legal obligations. Finally, the custodian must undertake the supervisory function for the management duties performed by the SGIIC or the directors, as the case may be.

2.4 Other sources

In addition to the specific regulatory frameworks governing each individual type of an institutional investor, a number of other sources shape and define their duties regarding investment decision-

³¹⁰ Primarily, Law 35/2003, of 4 November 2003, on collective investment schemes (*Ley 35/2003, de 4 de noviembre, de instituciones de inversión colectiva*) and Royal Decree 1393/1990, of 2 November 1990 (*Real Decreto 1393/1990, de 2 de noviembre, por el que se aprueba el Reglamento de la Ley 46/1984, de 26 de diciembre, reguladora de las Instituciones de Inversión Colectiva y el Real Decreto 91/2001, de 2 de febrero, por el que se modifica parcialmente el Real Decreto 1393/1990*).

³¹¹ Primarily, Law 35/2003, of 4 November 2003, on collective investment schemes (*Ley 35/2003, de 4 de noviembre, de instituciones de inversión colectiva*) and Royal Decree 1393/1990, of 2 November 1990 (*Real Decreto 1393/1990, de 2 de noviembre, por el que se aprueba el Reglamento de la Ley 46/1984, de 26 de diciembre, reguladora de las Instituciones de Inversión Colectiva y el Real Decreto 91/2001, de 2 de febrero, por el que se modifica parcialmente el Real Decreto 1393/1990*).

making. Under Spanish law, the performance of any kind of activity directly or indirectly related to the Spanish securities markets must be carried out in compliance with: (i) the conduct rules provided by the Securities Market Law and (ii) the General Code of Conduct for the Securities Markets in Spain.³¹²

As a result, these companies (including investment companies and management companies) must:

- act with due skill, care, diligence and transparency in the interests of their customers and in order to safeguard the integrity of the market;
- try to avoid conflicts of interest between themselves and their customers;
- deal fairly with customers;
- request from their customers all the information necessary for the provision of services which they are contractually obliged to provide; and
- provide timely and appropriate information to their customers regarding the results and development of the services provided.

In this regard, customer surveys may be carried out to establish whether, and to what extent, ESG should be incorporated into investment decision-making, provided, at all times, that the proposed incorporation of ESG issues does not infringe any other piece of legislation (for example the principles for investments by collective investment schemes, pension funds or insurance companies). At the very least, it would seem (although there is no authority to suggest this, or, indeed, to suggest a view to the contrary) that the duty to act fairly means that all factors – not just financial ones – ought to be considered.

3 INTEGRATION OF ESG CONSIDERATIONS INTO INVESTMENT DECISION-MAKING

3.1 Pension funds

Currently there are no legal provisions for, or explicit prohibitions against, taking account of ESG considerations under Spanish law. It would appear, therefore, that as long as the legal principles and obligations discussed above and the rules of performance are duly complied with, ESG considerations may be taken into account (although there is no obligation to do so under Spanish legislation on pension funds).³¹³

Indeed, a few Spanish pensions funds are starting to incorporate ESG issues into their investment policies. For example, in 2003 the management committee of a pension plan created by Telefónica decided to give 1 per cent of its assets to ethical, social or ecological funds. Similarly, in September 2003, the management committee of a pension fund established by Vida Caixa decided to manage part of its assets following ethical and social criteria. Finally, BS Plan Ético y Solidario invests part of its funds in the underlying assets of the index FTSE 4 Good Europe.

3.2 Insurance reserves

Again, provided the principles and duties outlined above are duly complied with, ESG considerations may be taken into account (although there is no obligation to do so under Spanish insurance law) when choosing investments. As with pension funds, one of the principles that should be taken into account when making investment decisions is ‘profitability’.

3.3 Collective investment schemes

General approach

Provided the above principles and duties are complied with, there are no limitations under Spanish law restricting investment based on environmental, social or governance considerations. Therefore,

³¹² Approved under Royal Decree 629/1993, of 3 May 1993.

³¹³ Legislative Royal Decree 1/2002, 29 November 2002, by which the law on pensions plans and funds was approved (Real Decreto Legislativo 1/2002, de 29 de noviembre, por el que se aprueba el texto refundido de la ley de regulación de los planes y fondos de pensiones) and Royal Decree 304/2004, of 20 February 2004, by which the regulations on pension plans and funds were approved (Real Decreto 304/2004, de 20 de febrero, por el que se aprueba el reglamento de planes y fondos de pensiones).

investments by investment funds or investment companies may be chosen according to the principles and obligations set out above as well as the relevant scheme's investment policies (this implies that ESG considerations may be taken into account, although this is not legally required as there is no specific legislation dealing with ESG considerations).

The INVERCO circular

The Spanish Association for Collective Investment Schemes and Pensions Funds (INVERCO) has issued a circular discussing what is meant by ethical, environmental or any other considerations that fall under the umbrella of social responsibility (the Circular).³¹⁴ Although the rules issued by this association are not binding, in practice all of INVERCO's members comply with its guidance.

The Circular distinguishes between 'ethical collective investment schemes' and 'caring collective investment schemes',³¹⁵ the main difference between the two being that while the managing company of the latter donates a portion of its management commission to NGOs or other types of charitable entities, the former complies with certain ethical, ecological or social responsibility criteria established in the collective investment scheme's prospectus.

The Circular further establishes classification criteria used when screening investments by collective investment companies, which can be listed as follows:

- negative criteria (ie those that exclude investment in companies whose income, in whole or in part, is derived from activities that do not correspond to the ethical principles espoused by the scheme); and
- positive criteria (ie those that encourage investment in companies that positively contribute to the development of the scheme's ethical principles).

The two sets of criteria may be combined and weighed-up (for example, the scheme may choose not to invest in a company if more than 10 per cent of its income is derived from activities grouped under the 'negative criteria').

The Circular also establishes that collective investment schemes' prospectuses must specify the ethical criteria according to which the collective schemes' portfolios will be constructed. In addition, it envisages the establishment of an 'ethics commission' within each scheme. The 'ethics commission' would classify securities and other financial instruments according to the collective scheme's ethical criteria, with the view to enabling the SGIIC to decide which entities to invest in, or to divest from, based on the list provided by the ethics commission.

The Circular also says that there would be no need for an ethics commission within schemes:

- that are either restricted in their investment practices to investing in securities included in 'ethical' indexes published by third parties, or in securities that benefit from being classified as ethical by a specialised entity and are defined in the prospectus; or
- that invest in collective investment schemes classified by specialised entities as 'ethical collective investment schemes' only.

The quarterly reports of any such collective investment scheme must contain information outlining its investment approach.

BBK Solidaria, FI is an example of this type of a collective investment scheme. Its investment policy does not allow the scheme to invest in companies whose economic activities come into conflict with human rights, international justice and peace. In addition, BBK Solidaria, FI sets out negative criteria (such as child exploitation, arms manufacture, sale of alcohol or tobacco or anti-environmental practices) and positive criteria (such as positive labour relations, respect of employees' fundamental rights, equal opportunities, respect for the environment or transparency of management).

³¹⁴ Dated 15 November 1999.

³¹⁵ 'IICs Solidarias'.

Finally, it should be noted that according to a recent press release, the first collective investment scheme, known as the Spanish fund on good governance,³¹⁶ has recently filed for registration. According to the press release, this fund will be the first one to make use of corporate governance principles as it will invest only in the ‘best-governed’ Spanish companies.

4 SUMMARY

There are no provisions under Spanish investment law dealing with environmental, social or governance considerations in investment decision-making. There is no legislation, case law or other regulatory guidance on shareholder activism under Spanish law. Therefore, in our opinion, investments by pension funds, collective investment schemes and insurance companies taking into account environmental, social or governance considerations may be permitted (although it is not legally required). However, it is necessary to bear in mind that the principles and obligations as discussed regarding each type of investor in this section of the report must be duly complied with at all times.

³¹⁶ ‘Fondo Español de Buen Gobierno’, *Expansión*, 31 March 2005.

1 INSTITUTIONAL INVESTMENT

There is a growing recognition among policymakers and stakeholders in the UK that the economic power wielded by institutional investors ought to be harnessed to meet social and environmental needs through the wider integration of ESG considerations into investment decision-making. A survey conducted in 2000, shortly after the UK government had introduced a requirement that pension trustees disclose the extent to which they take ESG considerations into account, found that over half of the respondents were incorporating ‘SRI principles’ into their decision-making.³¹⁷ A number of current government and industry-led initiatives seek to encourage a wider take-up of these principles.

However, for a significant part of the UK investment industry there are perceived barriers to greater integration of ESG issues into investment decision-making. First among these is a perception that those responsible for managing trusts with a financial purpose, such as pensions, are required by their fiduciary duties to put ‘profit maximisation’ above all other considerations. This perceived requirement is seen as effectively precluding the use of strategies such as negative screening, where such strategies are shaped by anything other than seeking the highest financial return.³¹⁸

The following analysis demonstrates that this perception is based on a fundamental misunderstanding of the law and the outdated notion that investment decision-making is based on individual investments rather than modern portfolio theory. Today, it is likely that a court would in many circumstances view investment decisions that are made having regard to ESG considerations as appropriate.

Public and private pensions

A number of different types of pension are available in the UK. Large companies commonly provide their employees with access to an ‘occupational pension scheme’. Certain public pension funds, such as the pensions scheme of employees of the state-owned National Health Service, are not funded in advance and paid out of the proceeds of investment; their management is therefore outside the scope of this review.³¹⁹ Other public pension funds, such as those established under the statute-based Local Government Pension Scheme, are funded and are subject to the same legal rules as those discussed below with respect to occupational pension schemes established by private employers.³²⁰

³¹⁷ E. Mathieu, *Response of UK Pension Funds to the SRI Disclosure Regulation*, UK Social Investment Forum (‘UKSIF’), October 2000. The sample included large and small private funds and local authority funds.

³¹⁸ This is necessarily a simplistic statement of the position but is intended to reflect the concerns that have arisen from the received understanding of the decision in *Cowan v Scargill* [1984] 3 WLR 501, which have ‘long [been] seen as effectively precluding pension scheme trustees from engaging in SRI’: *Socially Responsible Investment: A Guide for Pension Schemes and Charities*, edited by C. Scanlan, London, Key Haven Publications, p. 79.

³¹⁹ Employee contributions are used to pay benefits due to other members rather than being invested.

³²⁰ Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998/1831 provide:

‘Use and investment of pension fund money

9. (1) An administering authority must invest any fund money that is not needed immediately to make payments from the fund.
- (2) They may vary their investments.
- (3) Their investment policy must be formulated with a view –
 - (a) to the advisability of investing fund money in a wide variety of investments; and
 - (b) to the suitability of particular investments and types of investments.
- (4) An administering authority must obtain proper advice at reasonable intervals about their investments.
- (5) The authority must consider such advice in taking any steps about their investments.’

Personal pension funds (including so-called ‘stake-holder’ pensions) are provided by financial institutions on an elective basis.

Insurance reserves

Insurance companies are required to keep a separate fund for long-term reserves, such as reserves backing life insurance policies, and to observe certain limits on investment in certain classes of investment assets (such as unquoted shares) but are otherwise not subject to any particular legal requirements governing how they invest their reserves. In practical terms, their duties as regards their management of reserves are limited to their contractual duty to meet the terms of their insurance policies.

Mutual funds

Mutual funds are known as ‘unit trusts’ in the UK. They are frequently offered to investors on the basis that investments by the fund will be limited to a particular asset profile, such as real estate or quoted equities. Specialist SRI funds are available but the following discussion is concerned with mainstream funds.

2 THE LEGAL CONTEXT FOR INVESTMENT DECISION-MAKING

In discussing the legal context in which institutional investment decisions are made in the UK, it is necessary to draw a distinction between funds that are established as trusts and those that do not adopt a trust structure. Occupational pension funds and certain public sector pensions (as noted above) are structured as trusts,³²¹ as are mutual funds.³²² Insurance reserves are not typically managed under a trust structure, while personal or private pensions established by individuals may or may not be structured as trusts, depending upon the plan chosen. Certain public pension funds, such as the pensions scheme for employees of the National Health Service, are not funded in advance and their management is therefore outside the scope of this review.³²³

Law in the UK³²⁴ places a range of duties and obligations on the decision-makers who control these funds (namely trustees, fund managers and investment consultants). These duties and obligations are derived from legislation and case law³²⁵ and two broad categories are relevant to the decision-makers’ ability to integrate ESG considerations into their decision-making:

- fiduciary duties (which in some cases have been modified or supplemented by statute, particularly regarding the management of pension funds).³²⁶ These fiduciary duties apply only to funds structured as trusts; and
- non-fiduciary duties under contract law and the law of negligence, which apply regardless of the fund structure.

³²¹ A trust is the preferred vehicle for occupational pension funds in the UK because the fund is insulated from the sponsoring employer, preventing the assets of the fund being made available to creditors if the sponsoring employer defaults on its debts. In the pension context, a trust is thus fundamentally a means of protecting beneficiaries, with the trustee in the role of independent custodian of the beneficiaries’ retirement savings.

³²² As with occupational pensions, a trust structure insulates the assets of the fund from the entity that manages them. There are also certain tax benefits associated with the trust structure. A range of other pooled investment vehicles is available in the UK, including open-ended investment companies and ‘investment trusts’. These are not operated via a trust structure in the legal sense but as companies.

³²³ Employee contributions are used to pay benefits due to other members, rather than being invested.

³²⁴ England and Scotland have different legal systems. English law is based on common law whereas Scots law is a mixture of civilian law and English law. For the purposes of this discussion, we do not in general distinguish between the two legal systems.

³²⁵ Tables summarising the duties of these decision-makers and the key statutory provisions that apply to them are contained in Appendix [H] to this report. It should be noted that where there is a conflict, legislation prevails over case law in the UK.

³²⁶ See for example, Pensions Act 1995, s36.

The most important of these two categories is fiduciary duties. These are discussed in section 3 and section 4 below. The non-fiduciary duties are discussed briefly in section 5.

3 FIDUCIARY DUTIES – TO WHOM DO THEY APPLY?

Fiduciary duties apply to trustees directly and also to fund managers and investment consultants indirectly, where they provide services or advice on funds held under a trust.

Trustees

‘Trustees act as the ultimate decision-makers for pension funds. Even though they delegate certain investment responsibilities to others, they still define the framework and objectives.’³²⁷

Fiduciary duties apply directly to any person acting in the capacity of a trustee.³²⁸ Trustees cannot avoid the responsibilities imposed on them by their fiduciary duties – while they are permitted³²⁹ to delegate part or all of their investment discretion to specialist fund managers,³³⁰ they retain a duty to monitor the management of the investment by the fund manager. Occupational pension fund trustees, for example, will only avoid responsibility for any ‘acts or defaults’ of a fund manager in the exercise of a delegated discretion if they have taken ‘reasonable steps’ to satisfy themselves that:

- the fund manager has the knowledge and experience appropriate for managing the investments of the scheme; and
- the fund manager is ‘carrying out his [or her] work competently’ and in accordance with the required standards of prudence.³³¹

Trustees of occupational pension funds and pensions for local government employees must also prepare and maintain a written statement of ‘the principles governing decisions about investments’ (called a Statement of Investment Principles or SIP) with which the fund manager must comply.³³² The impact of this requirement is discussed in more detail below.

³²⁷ Myners, *op.cit.*, para. 2.5.

³²⁸ A ‘trustee’ is a person bound under a trust arrangement to control property on behalf of another: D.J. Hayton, *Underhill & Hayton’s: Law of Trusts and Trustees*. 15th edition, London, Butterworths, p. 1.

³²⁹ Legislation provides such a power even where the trust deed does not: Trustee Act 2000, s11; Pensions Act 1995, s34.

³³⁰ Pensions Act 1995, s 34(2)(a). Traditionally, pension trustees have tended not to be investment professionals but rather officers of the sponsoring employer and as such often have limited expertise: see P. Myners, *op. cit.*, para. 2.7.

³³¹ Pensions Act 1995, s34(4). The courts have not yet considered the effect of these provisions and there is some uncertainty as to the extent to which they relieve pension trustees of their responsibility for ensuring that their fiduciary duties are met in decisions about investments. However it appears that in requiring trustees to monitor the work of the fund manager to whom their discretion has been delegated, the legislation effectively places the ultimate responsibility for the appropriate management of the fund with the trustees.

³³² Pensions Act 1995, s36(5); The Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998, s.9A. In the case of other trusts, trustees must prepare a written ‘policy statement’ setting out guidance as to how any delegated asset management functions should be exercised by the fund manager: Trustee Act 2000, s15(2).

Fund managers and investment consultants

Fiduciary duties do not apply directly to fund managers or investment consultants in typical circumstances, because they do not act as custodians of fund assets in the way that trustees do.³³³ However, fund managers and, to a lesser extent, investment consultants³³⁴ are often effectively subject to the same obligations as trustees regarding their decision-making or advice, because:

- legislation places them under such obligations in certain circumstances;³³⁵
- where fund managers are retained by trustees, or investment consultants are retained by trustees or by fund managers acting on the trustees' behalf, their contractual duty is usually to provide management services or advice to the trustees to enable the trustees properly to discharge their fiduciary duties; they must therefore, in their decision-making or advice, have proper regard to the obligations imposed on the trustee by those fiduciary duties, or risk breaking the terms of their contract; and
- they may be found negligent if they fail to have proper regard to the obligations imposed on those to whom they are providing investment services or advice.

It follows that fund managers and investment consultants must have regard to the fiduciary duties governing investment by trustees in their institutional investment work.

4 FIDUCIARY DUTIES: WHAT DO THEY REQUIRE?

Fiduciary duties set out the broad parameters within which trustees (and the fund managers and investment consultants whom they have engaged) must exercise the discretionary powers conferred by the terms of the trust. Crucially for our purposes, fiduciary duties affect the exercise of the discretion to make and manage investments. In that regard, trustees and their agents must ensure they act prudently and for a proper purpose.

The duty to act prudently

This duty can be understood as both regulating the level of risk that may be accepted on beneficiaries' behalf and imposing a 'duty of care' that dictates the level of attention decision-makers must apply when making their investment decisions. The legislature and the courts have articulated the duty in a variety of ways, but essentially those under a fiduciary duty must:

- exercise the 'care, skill and diligence' a prudent person would exercise, not just when dealing with their own investments, but when dealing with investments for someone else for whom they feel 'morally bound to provide';³³⁶
- apply the special knowledge and experience they possess or, if they are professional trustees, the skills expected of a professional trustee;³³⁷
- have regard to the need for 'diversification of investments', in so far as appropriate to the circumstances of the trust;³³⁸

³³³ It has been argued that fund managers may in certain circumstances be subject to fiduciary duties directly, such as where they control investments on behalf of others and have a wide discretion as to how they manage the investments; but these arguments have yet to be tested before the courts. See S.Willey, 'Investment management and fiduciary duties' in *Law and Regulation of Investment Management* (London, Sweet and Maxwell), p.237.

³³⁴ Investment consultants are in a different position to fund managers because they do not exercise any discretion on behalf of trustees but rather merely provide advice.

³³⁵ Fund managers exercising delegated investment powers for occupational pension fund trustees must properly assess the suitability of each investment and have regard to the need for diversification, for example: Pensions Act 1995, s 36. These are both recognised elements of the common law fiduciary duty of prudence.

³³⁶ *Re Whiteley* (1896) 33 Ch D 347 at 355. The distinction has been said to be 'between a prudent degree of risk on the one hand and hazard on the other': *Bartlett v Barclays Bank Trust Co (No 1)* [1980] Ch 515 at 531.

³³⁷ Trustee Act 2000, s 1. This statutory duty of care strictly does not apply to trustees of occupational pensions when exercising any 'power of investment': Trustee Act 2000, s36. However they remain under an equivalent duty at common law: *Bartlett v Barclays Bank* at 534.

- have regard to the ‘suitability’ of each investment;³³⁹
- obtain and consider ‘proper advice’ on certain matters, such as whether an investment complies with the SIP required for occupational pensions;³⁴⁰
- take account of all relevant considerations and ignore irrelevant considerations.³⁴¹ There is little helpful case law on the question of precisely what will constitute relevant considerations in an investment context, but in our view, a decision-maker ought to have regard to all those considerations that a reasonable person in the decision-maker’s position would expect could materially influence the performance of the investment or investments in question over the relevant time horizon;³⁴² and
- act reasonably.³⁴³ Investors must be 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.³⁴⁴ Subject to the duty below to act in the interests of beneficiaries, the law does not mandate any particular decision – the weight to be given to one

³³⁸ Pensions Act 1995, s 36; Trustee Act, s4(3)(b). This requirement is expected to be replaced for occupational pensions with a set of more prescriptive guidelines implementing the requirements of the EU Occupational Pensions Directive. These reforms were due to be introduced by 23 September 2005 but are not now expected until October 2005 at the earliest. Under these new provisions, trustees must exercise their powers of investment in accordance with draft Occupational Pension Schemes (Investment) Regulations 2005 (the OPSIR). The OPSIR are expected to require that trustees use their investment powers in a manner calculated to ensure the ‘security, quality, liquidity and profitability of the portfolio as a whole’, among other things. For more details, see the table of UK statutory provisions in the appendices to this report.

As to the meaning of ‘appropriate’ diversification, Nicholls in *Harries v Church Commissioners* [1992] 1 WLR 1241 appeared to take the view that adopting an ethical investment policy that excluded ‘about 37 per cent’ of listed United Kingdom companies (by value), including two companies which made up 65 per cent of the oil sector and a further two companies which made up 62 per cent of the chemical sector, ‘would be much less balanced and diversified’ such that it could not be considered to be prudent: *Harries v Church Commissioners* at 1251. On the other hand, he also said: ‘It is not easy to think of an instance where in practice the exclusion ... of one or more companies or sectors from the whole range of investments open to trustees would be likely to leave them without an adequately wide range of investments from which to choose a properly diversified portfolio’: *Harries v Church Commissioners* at 1246.

³³⁹ Pensions Act 1995, s 36; Trustee Act, s 4(3)(a). This requirement is also expected to be amended with respect to occupational pension funds (see previous footnote). Leaving aside this amendment, this requirement must in our view be read in light of modern portfolio theory, which assesses the suitability of individual investments as part of a portfolio as a whole. The courts have recognised the impact of modern portfolio theory on fiduciary duties: see *Nestle v National Westminster Bank plc (No 2)* [1993] 1 WLR 1260.

The Charity Commission has issued guidance on charitable trusts advising that the question of suitability of investments for charities includes ‘any relevant ethical considerations as to the kind of investments that are appropriate for the trust to make’: Charity Commission, *Operational Guidance: Trustee Act 2002 - General Power of Investment*, February 2002 (www.charity-commission.gov.uk/supportingcharities/ogs/index086.asp, accessed 27 July 2005).

³⁴⁰ Pensions Act 1995, s36(3), Trustee Act, s5. For certain types of investments, the advice must be sought from a person authorised under FSMA; otherwise from a person reasonably believed to be qualified to give the advice. The duty to seek advice on matters beyond trustees’ expertise is also recognised in the cases: see eg *Martin v City of Edinburgh District Council* [1989] Pensions Law Reports 8 (Court of Session).

³⁴¹ This duty is akin to the duty on government officials and other decision-makers exercising powers subject to judicial review. *Abacus Trust Co (Isle of Man) v Barr* [2003] EWCH 114 (Ch) held that the court would interfere with a trustee’s exercise of discretion if it was clear that the trustee would have acted differently if s/he had taken all relevant considerations into account. See also *Re Hastings-Bass* [1975] Ch 25.

³⁴² See G. Yaron, 2005, op. cit, p. 9; *Tesco Stores Ltd v Secretary of State for the Environment* [1995] 1 WLR 759; D Herling, Weight in Discretionary Decision-Making, *Oxford Journal of Legal Studies* (1999) 19 583.

³⁴³ As established in *Associated Provincial Picture Houses Ltd v Wednesbury Corporation* [1947] 2 All ER 680. *Council of Civil Service Unions v Minister for the Civil Service* [1984] 3 All ER 935 provides a test of legality based on concepts of irrationality, perversity or absurdness.

³⁴⁴ For a useful discussion of the law’s treatment of the duty to weigh up competing considerations in the context of the *Tesco Stores* case, see D. Herling, ‘Weight in Discretionary Decision Making’.

factor as against another is for the investor to decide³⁴⁵. Nor does the law judge a decision with the benefit of hindsight – as a US judge put it, ‘the fiduciary duty of care requires prudence, not prescience.’³⁴⁶ Courts assess investment decision-making on process not performance, holding decision-makers to account for the care that they apply to their decisions, not the accuracy of their predictions.³⁴⁷

What does the duty to act prudently mean in practice? The requirements above are not clearly defined in the legislation or case law. There is no single benchmark of prudence against which conduct can be measured in every case. Indeed, the courts have recognised that concrete benchmarks against which to assess conduct are unworkable, because investment practices evolve as economic circumstances change.³⁴⁸ In a decision in 1993, for example, the Court of Appeal recognised that modern portfolio theory altered the way in which the prudence of investments should be assessed, in that the risk level of the whole portfolio had become the relevant question, rather than that of individual investments as was formerly the case.³⁴⁹ This is a reflection of the organic nature of fiduciary duties, which evolve over time to reflect changing social norms and values.³⁵⁰ Regulations are expected to be enacted in the near future modifying the duties of prudence with respect to occupational pension funds so as to refer to a duty to ensure the ‘security, quality, liquidity and profitability of the portfolio as a whole’.³⁵¹

The duty to act for a proper purpose

Alongside their duty to act prudently, trustees must also exercise their investment powers for a proper purpose: that is, the purpose for which the trust was established.³⁵² This means that investment powers must be exercised for the express purposes stated in the instrument creating the power, namely the trust

³⁴⁵ *Edge v Pensions Ombudsman* [2000] Ch 602 at 626G-627D. Judges are reluctant to interfere with decisions by trustees because they recognise that trustees are likely to be in a much better position to identify and weigh the relevant factors than the court can hope to be: *Edge v Pensions Ombudsman* at 630F. Similarly, courts generally have recognised that decisions involving the application of expertise, such as valuing land, should not be subject to review unless improper considerations were taken into account or the decision-making process was otherwise manifestly unsound: see eg *Guppy’s (Bridport) Ltd v Carpenter* (1973) EGD 429.

³⁴⁶ *DeBruyne v Equitable Life Assurance Society of the US*, 920 F.2d 457 (1990); Yaron, *A Flexible Approach*, op. cit.

³⁴⁷ As Paul Myners recognised, investment managers seeking to maximise returns will select securities ‘in the belief that the market has mispriced them. Whether the market corrects itself within the time period under measurement ... is often a matter of chance’: Myners, op. cit, para. 5.46. The Courts will not lightly hold an advisor liable where an investment decision turns out in retrospect to have been unfortunate: see eg *Stafford v Conti Commodity Services* [1981] 1 All ER 691.

³⁴⁸ *Steel v Wellcome Custodian Trustees* [1988] 1 WLR 167 at 171-172. Historically, trustees were limited in the types of investments they could make pursuant to a statutorily implied power of investment (eg to government bonds and approved lists of other investments) but changing attitudes to risk have resulted in the progressive relaxation of these restrictions, to the point where today, unless the terms of the trust provide otherwise and subject to their fiduciary duties, trustees can make almost any of the investments available to an individual. See S.J.G. Lloyd, *A Practitioners Guide to Powers and Duties of Trustees*, London, Butterworths, 2002, para. 3.2. The very definition of ‘investment’ has been recognised by the Law Commission as an ‘evolving concept to be interpreted by the courts’: Law Com No 260 at para 2.28, footnote 56.

³⁴⁹ *Nestle v National Westminster Bank Plc (No. 2)* [1993] 1 WLR 1260 at 1268 per Lord Justice Dillon. See also the lower court decision of Hoffmann J, which was upheld on appeal: reported at [2000] Wills and Trusts Law Reports 975 (but dated 29 June 1988).

³⁵⁰ Last century, for example, fiduciary duties were held to preclude local authorities from applying a standard minimum wage for adult men and women and providing subsidised public transport: see *Roberts v Hopwood* [1925] AC 578; *Prescott v Birmingham Corporation* [1955] Ch 210; *Bromley London Borough Council v Greater London Council* [1982] 2 WLR 62.

³⁵¹ Draft Occupational Pension Schemes (Investment) Regulations 2005 (the OPSIR).

³⁵² See, eg, *The Duke of Portland v Lady Topham* (1864) 11 HL Cas 32 at 54: ‘Powers must be exercised fairly and honestly for the purposes for which they are given and not so as to accomplish any ulterior motive’. Actions beyond power will be invalid even where they are motivated by a genuine desire to serve the interests of the beneficiaries: *Hillsdown Holdings plc v Pensions Ombudsman* [1997] 1 All ER 862.

deed and rules.³⁵³ Accordingly, under UK law, the way to ensure that ESG considerations are integrated into investment decision-making is for the relevant instruments to expressly require such integration, or to be amended to require it, as in the case of specialised ‘ethical’ funds.³⁵⁴ Charitable trusts are also often established under a trust deed that expressly deals with how the charity’s funds are to be invested. The Charity Commission, which has responsibility for supervising UK charities under the Charities Act 1993, has issued guidance emphasising that charities can make investments that do not seek the best financial returns, providing they further the organisation’s charitable purpose.³⁵⁵

Most mainstream UK funds are established under trust deeds that provide a wide power of investment and do not stipulate any particular approach to ESG issues, however.

In 1984, Megarry V-C held in *Cowan v Scargill*³⁵⁶ that where the purpose of a trust is to provide financial benefits,³⁵⁷ powers of investment under the trust must be exercised ‘so as to yield the best return for the beneficiaries’, taking into account risks of the investments in question. In considering what investments to make, in his view trustees must put their own personal interests and views to one side and simply adopt the most ‘beneficial’ investment.³⁵⁸ This decision has since been interpreted by some members of the investment community as imposing a duty to obtain the maximum rate of return possible, effectively precluding trustees and their fund managers and advisers from having regard to any considerations, other than the maximisation of financial returns.³⁵⁹

However, there are powerful reasons why *Cowan v Scargill* is not good authority for this proposition. In our view, were a court asked today to rule on the legality of a properly considered and administered ESG investment policy, *Cowan v Scargill* would not be determinative of the matter. These reasons are summarised below.

³⁵³ This principle is of general application – and is as applicable to charitable trusts as it is to general pension funds: see *Harries v Church Commissioners* at 1246. Trust deeds will be interpreted so as to give ‘reasonable and practical effect to the scheme, bearing in mind that it has to be operated against a constantly changing commercial background’: *Re Courage Group’s Pensions Schemes* [1987] 1 All ER 528 at 536. It is via the terms of the trust that investors in unit trusts established with a particular investment profile (eg property or equities) ensure that the profile is adhered to by those responsible for managing the fund.

³⁵⁴ See, eg *Re Courage*, at 528 for the principles applicable to powers to amend a pension trust deed.

³⁵⁵ Charity Commission, *Guidance on Programme-Related Investment*, May 2001 (www.charity-commission.gov.uk/supportingcharities/casi.asp, accessed 27 July 2005).

³⁵⁶ This case concerned a dispute under a mineworkers’ pension scheme set up by the National Coal Board in which 5 of 10 trustees were appointed by the Board and 5 by the National Union of Mineworkers (‘NUM’), with no provision for a casting vote. In 1982 the Board proposed a revised investment plan. The NUM trustees refused to ratify the revised plan unless it was amended so that no overseas investments or investments in energies competing with coal could be made. The Board Trustees sued the Union Trustees, alleging that their refusal to ratify the revised plan amounted to a breach of trust.

³⁵⁷ See *Cowan v Scargill* at 513.

³⁵⁸ See *Cowan v Scargill*, at 514. Although Megarry acknowledged that ‘arrangements which work to the financial disadvantage of a beneficiary may yet be for his benefit’, such as where the beneficiaries share a moral aversion to profiting from a particular industry, he indicated that this would only ‘rarely’ be the case: *Cowan v Scargill*, at 515. See further below in box headed “Best Interests”.

³⁵⁹ Scanlan, *op. cit.*, p. 79.

Why *Cowan v Scargill* is not a reliable legal authority³⁶⁰

- The case considered a narrow point and should be limited to its particular facts.ⁱ
- Much of what Megarry states is obiter dicta and as such not binding.ⁱⁱ
- Scargill represented himself and there was no equality of argument.ⁱⁱⁱ
- Scargill was not a lawyer and made political and ideological points but not technical legal points.^{iv}
- The case was not properly argued.^v
- There was no previous authority on point.^{vi}
- The defendant NUM trustees had fettered their discretion.^{vii}
- The NUM trustees had an ulterior purpose, namely propping up the ailing British coal industry.^{viii}
- Supporting the coal industry was clearly not in the interests of all the beneficiaries.^{ix}
- Megarry did not think Scargill had acted with integrity.^x
- The case involved a blanket prohibition of certain investments.^{xi}
- The investment plan in dispute bore little or no resemblance to a modern ESG investment policy.^{xii}
- The case was decided 21 years ago, before legal acknowledgment of modern portfolio theory.^{xiii}
- There was no recognition of the unique nature of the trust in question.^{xiv}
- The case took place against a politically charged context but the opposing trustees were sympathetic to the NUM trustees' case.^{xv}

For these reasons, we think that no court today would treat *Cowan v Scargill* as good authority for a binding rule that trustees must seek the maximum rate of return possible with every individual investment and ignore other considerations that may be of relevance, such as ESG considerations.³⁶¹ Rather a court would look to the underlying principle of fiduciary law on which Megarry's decision was based, namely that investment powers must be exercised carefully and fairly for the purposes for which they are given and not so as to accomplish any ulterior purpose.³⁶² Seen in this light, the decision suggests that it is a matter of process and that pension fund trustees will fulfil their fiduciary duties provided they treat the purpose of the investment power (which for pension funds and other financial trusts will ordinarily be to seek a financial return for the beneficiaries) as the primary purpose, and, while allowing for the influence of other relevant considerations, do not allow it to be overridden by any other purpose.

Cases since Cowan v Scargill

This principled approach was followed in a Scottish case decided not long after *Cowan v Scargill*.³⁶³ In that case, Lord Murray held that, on his reading of *Cowan v Scargill*, trustees have a duty not to fetter their investment discretion for reasons extraneous to the trust purposes, including reasons of a political or moral nature. However, Lord Murray added that this does not mean that a trustee, in genuinely applying his or her mind to a trust decision, must 'divest him or herself of personal preferences, or political, moral and religious beliefs'. According to Lord Murray, what the trustee must do is 'to recognise that he has those preferences, commitments or principles but nonetheless do his best to exercise fair and impartial judgement on the merits of the issue before him'.³⁶⁴

In the other important case decided shortly after *Cowan v Scargill*, the court found no difficulty with the trustees of a charitable church trust negatively screening investments deemed to be inconsistent

³⁶⁰ The footnotes supporting the statements in this box can be found at the end of the section, under the heading '*Cowan v Scargill* references'

³⁶¹ For support for this view, see eg Farrar & Maxton, op. cit., Yaron, 2005, op. cit. and Scanlan, op. cit.

³⁶² Indeed, it is cited in these terms in *Cowan v Scargill*.

³⁶³ *Martin v The City of Edinburgh District Council* [1989] Pensions Law Reports 8 (Court of Session).

³⁶⁴ *Ibid.* at 16. It is important to note, however, that trustees will not discharge their duties merely by acting with genuine motives: 'Honesty and sincerity are not the same as prudence and reasonableness': *Cowan v Scargill* at 515.

with the purposes of that church.³⁶⁵ Again, the court emphasised the requirement on trustees to abide by the purpose of the trust – trustees ‘must not use property held by them for investment purposes as a means for making moral statements at the expense of the charity of which they are trustees’ – but this did not prevent them acting as ‘responsible shareholders’.³⁶⁶

5 NON-FIDUCIARY DUTIES

In addition to the fiduciary duties to act prudently and for a proper purpose, investment decision-makers are also subject to a range of non-fiduciary duties that impact upon their decision-making powers and obligations. These comprise:

- duties under the general law of negligence, which require providers of investment services or advice to apply a standard of care to their work that is reasonable having regard to their qualifications and expertise; and
- duties under contract, including a general duty to apply due skill and care.

These duties are examined briefly below.

Negligence

There is not currently a developed body of law dealing with the standard of care expected of investment decision-makers such as trustees, fund managers or investment advisors as there is for doctors or accountants, for example. The question whether a particular investment decision or piece of advice was made or given negligently will depend upon whether the conduct in question measures up against the standard of reasonable care that is appropriate to the circumstances. The courts look to the standards that are generally prevailing in the speciality or profession in determining what level of care is required: that is, ‘the accepted professional practice’.

Setting the standard of care in this way operates as a substantial barrier to successfully suing a professional defendant in that there need only be a body of other professionals who support the practice said to be negligent for a claim to be defeated and we think this means that in practice the duty not to act negligently is of minimal assistance in defining investment decision-makers’ duties in taking ESG considerations into account³⁶⁷. Until doing so becomes an invariable part of investment management, the courts are unlikely to pro-actively require it; the corollary of this is that they are unlikely to rule against the practice when there is a body of professionals who take ESG considerations into account³⁶⁸.

Contract

We have seen that funds managers and investment consultants enter into contracts under which they provide investment management services or advice. Examples of these agreements include the investment management agreements under which pension trustees delegate their investment discretion

³⁶⁵ *Harries v Church Commissioners*.

³⁶⁶ *Harries* at 1247. The court did not explain what it meant by ‘responsible’ in this context, although the judge did indicate that trustees ‘consciences must not be too tender’, citing *Buttle v Saunders* [1950] 2 All ER 193, a case in which trustees were held to have failed to have acted in their beneficiary’s interest when they declined a late offer to purchase trust property in favour of a lower offer they felt bound to accept under their professional ethics.

³⁶⁷ Thus in *Maynard v West Midlands Regional Area Health Authority* [1985] 1 All ER 635, where there were two bodies of opinion as to the preferable approach to diagnosing a disease, the House of Lords held that the defendant was not acting negligently in following one of those approaches although damage would have been avoided had the other been followed. Nevertheless, there have been cases where professionals have been found liable even though they could show that their conduct was common amongst their peers: in one case the procedure used by banks for clearing cheques was held to be negligent by the House of Lords even though it had operated successfully for 40 years: *Lloyds Bank Ltd v EB Savory & Co* [1933] AC 201.

³⁶⁸ Complying with accepted professional practice means keeping up with developments in the field, but only when a new technique or approach has been approved and accepted as an invariable part of the accepted practice is a professional at fault in failing to adopt it. *Crawford v Charing Cross Hospital* [1977] 1 NZLR 394.

to fund managers. Certain terms are implied into contracts. These include a general duty to apply due skill and care.

Unless the contract in question expressly refers to the manner in which ESG considerations are to be dealt with by the person or firm providing the service or advice (which appears rarely to be the case for mainstream institutional funds), the courts are unlikely to impose any particular requirement as to how that is to be done. A decision-maker may be deemed to have agreed to observe the general standard of prudence as part of applying ‘due care and skill’ and as noted above, may be required to take account of the client’s fiduciary duties in conducting their work. It is unlikely in our view that a court would go beyond the terms of the contract so as to require a particular approach to ESG considerations.

The result is that for investment funds which are not structured as trusts (and which therefore are not subject to the law of fiduciary duties), the laws of negligence and contract impose minimal restrictions on decision-makers’ discretion to manage their investments as they see fit. The activities of such institutional investors will, like those of trustees, be influenced by the non-legal norms discussed in the next part of this section.

6 THE WIDER CONTEXT: GOVERNMENT AND INDUSTRY POLICY

The conduct of investment decision-makers is not governed only by narrow and formal common law duties. A range of other laws and norms also informs their conduct.

Government policy	
Statement of Investment Principles (SIP)	<p>In July 2000, the Labour government implemented a reform requiring occupational pension funds to disclose their policy on ESG issues as part of the SIP that all trustees are required to produce.³⁶⁹</p> <p>A SIP must now cover the trustees’ policy on:³⁷⁰</p> <ul style="list-style-type: none"> • diversification and suitability of investments; • meeting the minimum funding requirement; • kinds of investments to be held; • balance between different kinds of investment; • risk; • expected return on investments; • realisation of investments; • the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments; and • the exercise of the rights (including voting rights) attaching to investments.
Myners Principles	<p>In a report published in 2001 examining the factors that may distort the investment patterns of institutional investors, Paul Myners recommended the adoption of a series of principles that represented best practice for effective investment decision-making.³⁷¹</p>

³⁶⁹ Equivalent provisions are set out in The Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998, s.9A.

³⁷⁰ S35 Pensions Act 1995; Occupational Pension Schemes (Investment and Assignment etc) Amendment Regulations 1999, S.I. 1999/1849, s.2(4).

³⁷¹ Myners Review, op. cit.

	<p>Those principles were endorsed (with some amendments) by the government and a review was recently conducted to assess the extent to which they are being taken up.³⁷² The revised principles included:</p> <ul style="list-style-type: none"> • where investment decisions are made by trustees rather than fund managers, trustees should ensure that they have sufficient expertise, training and in-house support; • trustees should set clear objectives for their fund managers; • trustees should engage with the companies in which they invest where it is in the interests of their beneficiaries to do so;³⁷³ and • investment strategy and returns should be reported annually as part of a strengthened SIP.
Pensions Reform: the Pensions Act 2004	<p>The government has enacted the Pensions Act 2004,³⁷⁴ which amends certain aspects of the Pensions Act 1995. The amendments are being introduced in stages. They include:</p> <ul style="list-style-type: none"> • new requirements imposed on trustees to attain a certain level of knowledge and understanding of the trust deed and rules, the law relating to pensions and trusts and the 'principles relating to the funding of occupational pension schemes and investment of assets of such schemes';³⁷⁵ and • replacing the general duties of prudence set out above with more prescriptive requirements to the effect that investments must be made in a manner calculated to ensure the 'security, quality, liquidity and profitability of the portfolio as a whole'.³⁷⁶
UK government sustainability policies	<p><i>Securing the Future</i> is the latest UK government initiative on sustainable development that commits the government to consider the impact of all its policies on sustainable development at the key stages of the decision-making process. It states that:</p> <p>'The government is seeking to enable investors to engage more effectively in driving business change. As well as the Operating and Financial Review, we are working with big institutional investors, lenders and insurers... The amendment to the Pensions Act 1995 requiring pension schemes to state the extent to which they consider social, environmental or ethical issues in their investment strategy will continue to raise the profile of socially responsible investment. And within the</p>

³⁷² See HM Treasury, *Myners principles for institutional investment decision-making: review of progress*, December 2004. (www.hm-treasury.gov.uk/media/DCB/53/myners_principles_web.pdf, accessed 29 July 2005). The National Association of Pension Funds is expected to undertake a review of compliance in 2007 to enable the Government to assess whether further policy action is required: *UKSIF Briefing December 2004*, UKSIF (www.uksif.org/Z/Z/Z/lib/2004/12/brief-hmt-myners/index.shtml, accessed 1 August 2005).

³⁷³ The government proposes that trustees should comply with a statement of principles devised by the Institutional Shareholders' Committee ('ISC') and ensure that the principles are incorporated into fund managers' mandates. See table headed 'Industry Policy'.

³⁷⁴ The amendments have been made partly in order to meet the government's obligations under the EU occupational pensions directive of June 2003 'Directive on the activities and supervision of institutions for occupational retirement provision', 2003/41/EC. This directive is discussed in more detail in the EU section of this report.

³⁷⁵ Pensions Act 2004, s247(4). These requirements are due to come into force in April 2006 and were a response to the findings of the Myners Review that many trustees had an inadequate familiarity with the issues relevant to their role, including managing investments.

³⁷⁶ These requirements are contained in draft Occupational Pension Schemes (Investment) Regulations 2005 (the OPSIR).

	<p>Charity Sector, the new Statement of Recommended Practice highlights the need for charities to communicate with their stakeholders and the public how ethical considerations, which include sustainability considerations, influence their investment decisions. The government will also look at what can be done to empower individuals to make sustainable choices in how their money is invested. This could be helped by organizations offering employees a choice of an environmental or ethical fund for additional pension contributions.’</p> <p>‘The growing SRI market reflects the increasing recognition of non-financial factors in assessing company performance ... Our goal is to support the full integration of CSR into the way we do business. We will achieve this by ...engaging institutional investors on recognition of the impacts of social and environmental factors on long-term business performance.’³⁷⁷</p>
The London Principles	<p>The London Principles is a joint voluntary initiative between the Corporation of London and the UK government, promoting best practice in financing sustainable development by encouraging financial institutions to adopt seven core principles based on economic prosperity, environmental protection and social development.</p> <p>Principle 1: Provide access to finance and risk management products for investment, innovation and the most efficient use of existing assets.</p> <p>Principle 2: Promote transparency and high standards of corporate governance in themselves and in the activities being financed.</p> <p>Principle 3: Reflect the cost of environmental and social risks in the pricing of financial and risk management products.</p> <p>Principle 4: Exercise equity ownership to promote efficient and sustainable asset use and risk management.</p> <p>Principle 5: Provide access to finance for the development of environmentally beneficial technologies.</p> <p>Principle 6: Exercise equity ownership to promote high standards of corporate social responsibility by the activities being financed.</p> <p>Principle 7: Provide access to market finance and risk management products to businesses in disadvantaged communities and developing economies.</p>

The following further industry-led initiatives also encourage integration of ESG considerations into investment management.

Industry policy	
Association of British Insurers, Disclosure Guidelines on Socially Responsible Investment	These guidelines take the form of disclosures, which institutions would expect to see included in the annual report of listed companies. Specifically they refer to disclosures relating to board responsibilities and to policies, procedures and verification.
Combined Code on Corporate Governance	The Financial and Services Authority’s Combined Code provides that institutional shareholders should enter into a dialogue with companies in which they invest based on the mutual understanding of objectives and that institutional shareholders should apply the principles in the Institutional Shareholders’ Committee’s ‘The Responsibilities of Institutional Shareholders and Agents – Statement of Principles’, which should be reflected in fund manager contracts.

³⁷⁷ Taken from *Corporate Social Responsibility A Government Update*, (May 2004 www.societyandbusiness.gov.uk/pdf/dti_csr_final.pdf.)

<p>The Responsibilities of Institutional Shareholders and Agents – Statement of Principles</p>	<p>Produced by the Institutional Shareholders’ Committee (‘ISC’) which comprises the Association of Investment Trust Companies, Association of British Insurers, National Association of Pension Funds and Investment Management Association, these principles set out best practice for institutional shareholders and agents as to their responsibilities concerning investee companies and provide that institutional shareholders must:</p> <ul style="list-style-type: none"> ● set out their policy on how they will discharge their responsibilities – clarifying the priorities attached to particular issues and when they will take action; ● monitor the performance of, and establish, where necessary, a regular dialogue with investee companies; ● intervene where necessary; ● evaluate the impact of their activism; and ● report back to clients/beneficial owners.
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7 DECISION-MAKING AND ESG ISSUES: PRACTICAL GUIDANCE

The analysis above suggests that UK law assesses the propriety of investment decision-making against the following tests:

- was the correct process followed (that is, were all relevant considerations taken into account and a reasonable decision reached, having regard to the general standards of prudence);³⁷⁸ and
- was the decision motivated by a proper purpose?

Following the correct process

In interrogating the decision-maker’s decision, a court will inquire whether care, skill and diligence have been exercised by the decision-maker, whether regard has been had to the need for diversification and to the ‘suitability’ of each investment, and whether the decision-maker has taken into account all relevant considerations.

In addition, the court will seek to determine whether the trustee has acted reasonably: Has the trustee rationally considered the relevant considerations and arrived at a decision that could not be said to be absurd, perverse or irrational?

It is important here to note that the decision-maker must identify all relevant considerations before making a decision. Therefore, even where ESG considerations are ultimately rejected as having negligible weight (because they have little effect on the relative value of an investment, for example), we think they should form part of the basket of considerations to which a decision-maker has regard, and their weight assessed, in every decision to which they could reasonably be considered to relate.³⁷⁹ Some of the reasons why and circumstances in which ESG considerations constitute relevant considerations are set out below.

³⁷⁸ In other words, the choice of investments should be made ‘solely on the basis of well-established investment criteria, having taken expert advice where appropriate and having due regard to such matters as the need to diversify, the need to balance income against capital growth, and the need to balance risk against return’: *Harries v Church Commissioners* at 1246.

³⁷⁹ That fiduciary duties may require regard to ESG considerations is already the view of some stakeholders: ‘Our approach to fiduciary duties can be summarised as follows: maximum return on prudent basis taking proper advice where appropriate. We believe that if you don’t take factors such as environmental impact of your investment into consideration, you will be failing your fiduciary duties. There have been numerous studies showing that there is a positive correlation between good corporate environmental governance and financial performance of companies’. From an interview with Howard Pearce, Head of Environmental Finance and Pension Management Fund, EA, 11 July 2005.

Why ESG considerations are relevant considerations

- While there are differing views as to precisely how the links between ESG factors and financial performance should be identified and measured, the links are widely acknowledged to exist.³⁸⁰ The Carbon Trust, for example, has recently expressed the view that pension fund trustees have a duty to take into account the financial risk posed by climate change when making investment decisions.³⁸¹ Other stakeholders have indicated:
‘We strongly believe in full and consistent disclosure of CSR data by companies so that they can be included in fundamental company analysis, where we believe they belong.’³⁸²
‘Although no direct link was found between share price performance and good corporate citizenship we believe that it is a matter of time before these two issues become directly related.’³⁸³
- ESG considerations may help the decision-maker understand the nature, externalities, risk and likely return of the investments undertaken (for example, where the decision-maker is considering investments in a sector facing increased sustainability-driven regulatory control³⁸⁴);
- Understanding ESG considerations may assist decision-makers to adequately hedge and balance different types of investments or as part of building an appropriately diversified portfolio;
- By understanding ESG considerations, a decision-maker may better understand the likely longer-term viability and/or sustainability of certain investments;
- ESG considerations may assist decision-makers to understand the likely economic and political implications of sensitive investments – and any resulting effects for the value of such investments; and
- ESG considerations may assist decision-makers to understand how certain investments might reflect on the fund – especially if the fund was set up for particular purposes – and may be taken into account in considering any risk of damaging publicity (for instance, from investments in projects which are linked to international corruption or money laundering, or in regimes which commit gross human rights abuses or are subject to UN sanctions).

³⁸⁰ A study conducted by the Canadian-based investment research company, Innovest, and a large Wall Street investment bank showed that applying a set of environmental screens resulted in a risk-adjusted ‘out-performance’ premium for a range of standard portfolios. A ‘social index’ consisting of 60 Canadian companies that all passed a set of broadly-based social and environmental screens also out-performed the conventional market index by around five percentage points: see Yaron, *Answers to Common Questions*, op. cit., p. 6.

See also the work of WestLB, *Insurance & Sustainability, Playing with Fire*, March 2004, which shows ‘that sustainability is an independent return-driving factor that can have a positive impact on shareholder value beyond the influence of value, growth and size components’;

‘We are convinced that high sustainability performance stems from superior company management and will in the long run manifest itself in improved financial performance,’ said Robert Haßler, Oekom’s managing director cited in ‘Morgan Stanley Study Correlates Sustainability with Financial Outperformance’, by William Baue, December 05, 2003 (www.socialfunds.com/news/article.cgi/article1289.html); *More gain than Pain, SRI: Sustainability pays off* WestLB Panmure, 2002 ‘The findings of our study clearly suggest that it can pay to take the ‘sustainability factor’ into account when selecting stocks. There is an additional return even after risk adjustment’;

‘There was agreement that environmental, social and corporate governance issues affect long term shareholder value. In some cases, those effects may be profound ... They should be taken into account in fundamental financial analysis and thus investment considerations.’ UNEP FI, *The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing* (2004).

³⁸¹ According to the Carbon Trust, ‘even the most hard-nosed investors have to look at the financial impact of climate change’: reported in the *Sunday Telegraph*, 7 August 2005. The Carbon Trust is a government-funded body that helps companies cut carbon emissions and capture the commercial potential of low carbon technology.

³⁸² Anthony Ling, Co-director of Research, Goldman Sachs Europe, quoted in *The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing*, UNEPFI Report, June 2004, p. 27.

³⁸³ Russell Duckworth, Global Head of Equity Research, Deutsche Bank, quoted in *The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing*, UNEPFI Report, June 2004, p. 17.

³⁸⁴ The EU ETS scheme is an obvious example of this type of regulation.

Being motivated by a proper purpose

As well as expressing the view that investment powers must be used so as to yield the best return on an investment-by-investment basis (an aspect of his decision with which we disagree), Megarry in *Cowan v Scargill* also suggested such powers must always be used in the ‘best interests’ of beneficiaries.

‘Best interests’
<p>If Megarry’s statement that investment powers must be exercised in the beneficiaries’ best interests is taken to mean that trustees must always act in the interests of the beneficiaries rather than their own, in the sense that they must avoid any conflict of interest, it is undoubtedly correct.³⁸⁵ We also agree with the principle to the extent that it means trustees may take into account the broader interests of beneficiaries, beyond merely their financial interests. While Megarry suggested that such cases are likely to be ‘very rare’, he indicated that he could envisage ‘circumstances in which arrangements which work to the financial disadvantage of a beneficiary may yet be for his [or her] benefit’.³⁸⁶ He used the example of a group of beneficiaries who share ‘very strict views on moral or social matters, condemning ... alcohol, tobacco and popular entertainment’ and indicated that it would be lawful for such a trust to avoid such investments even if that resulted in a reduced financial return. This has similarities with the principle that charitable trusts are entitled to put the pursuit of their charitable purposes above the pursuit of profit.</p> <p>The US decision of <i>Withers v Teachers’ Retirement System of the City of New York</i>³⁸⁷ supports the view that trustees may make ‘imprudent’ investments where they are in the long-term best interests of beneficiaries. In that case, the court approved an investment by the teachers’ pension fund in New York City bonds as part of the plan to stave off the City’s bankruptcy. The investment was chosen, not for its return, but because of the risk that, if it was not made, the City would cease being able to contribute to the pension fund.</p>

There are clear practical difficulties involved in identifying a consensus among beneficiaries in order to justify a particular investment strategy.³⁸⁸ Nevertheless, we think there is a strong argument that there will be a class of investments that could reasonably be assumed offensive to the average beneficiary such that they could lawfully be excluded from an investment portfolio without all the beneficiaries’ express consent. That class of investments will not be fixed and a conservative approach is advisable, but the types of investment that might fall into that class include investments that are linked to clear breaches of widely recognised norms, such as international conventions on human rights, labour conditions, tackling corruption and environmental protection.³⁸⁹ Where it is practicable to survey the moral or social preferences of beneficiaries in order to arrive at an investment strategy that reflects their interests, we think that may assist trustees to justify a particular approach. However, little guidance is available from the case law as to whether unanimity is required or the precision with which beneficiaries’ preferences must be identified.³⁹⁰

³⁸⁵ *Boardman v. Phipps* [1967] 2 AC 46.

³⁸⁶ *Cowan v. Scargill* at 515.

³⁸⁷ 447 F.Supp 1248 (1978)

³⁸⁸ See e.g. *Harries v. Church Commissioners*, at 1251, where Nicholls said that ‘whether Christian ethics require a [particular] policy ... is a matter on which there can be literally endless argument’. See also X Frostick. *Is there a duty to act in the best interests of the beneficiaries?* (Seminar of the Association of Pension Lawyers, 3 November 1999); E Nugee QC, *The duties of pension scheme trustees to the employer* (1998) 12 *Trust Law International* 216; SEK Hulme QC, *The basic duties of trustees of superannuation trusts – Fair to one, fair to all?* (2000) 14 *Trust Law International* 130.

³⁸⁹ The instruments in which these norms are reflected, such as the International Covenants on Civil and Political Rights and on Economic, Social and Cultural Rights, are discussed in the international section of this report.

³⁹⁰ See *Harries v. Church Commissioners*, at 1247, where Nicholls said that ‘There will be instances today when those who support or benefit from a charity take widely different views on a particular type of investment, some saying that on moral grounds it conflicts with the aims of the charity, others saying the opposite. One example is the holding of arms industry shares by a religious charity. There is a real difficulty here. To many questions raising moral issues there are no certain answers. On moral questions widely differing views are held by well-meaning, responsible people. This is not always so. But frequently, when questions of the morality of conduct are being canvassed, there is no identifiable yardstick which can be applied to a set of facts to yield one answer which can be seen to be ‘right’ and the other ‘wrong’. If that situation confronts trustees of a charity, the law does not require them to find an answer to the unanswerable. Trustees may, if

In 1993, the Pensions Law Review Committee published a report³⁹¹ that endorsed the view that, where two or more investments or investment strategies were expected to be equally beneficial in financial terms, the pension trustees would be entitled to select the one they considered scheme members would prefer on ethical grounds. This has been described as the ‘tie-break’ principle.³⁹²

The Pensions Regulator has since issued guidance to trustees that expresses this principle in slightly different terms:³⁹³

As far as possible, when you decide on the investment strategy for the scheme, you should put aside your personal views on the ethical aspects of particular investments and get the best financial return that is achievable at the desired level of security or risk.

However, you can consider non-financial matters when comparing investments with the same potential return. So, you can choose a particular investment which you find more attractive for ethical reasons, as long as the ethical investment is likely to perform as well as, or better than, the non-ethical investment.

Some commentators suggest that where decision-makers take ESG preferences into account they should ensure that the preferences are those of their beneficiaries, not their own.³⁹⁴ However, the distinction between selecting investments because the decision-maker considers them to be more attractive from an ESG perspective or because they consider their beneficiaries would so view them is probably a fine one in practice and arguably the merit of the tie-break principle is that it avoids the need to point to unanimity in beneficiaries’ beliefs. We agree with the view expressed by Charles Scanlan that:³⁹⁵

On the assumption that the scheme suffers no financial harm... there is no trust law requirement to obtain the views of all beneficiaries; if the trustees can confer a non-financial benefit on a significant number of their beneficiaries, that should be sufficient justification.

This has the following implications for screening strategies employed in ESG investment.

they wish, accommodate the views of those who consider that on moral grounds a particular investment would be in conflict with the objects of the charity, so long as the trustees are satisfied that course would not involve a risk of significant financial detriment. But when they are not so satisfied trustees should not make investment decisions on the basis of preferring one view of whether on moral grounds an investment conflicts with the objects of the charity over another. This is so even when one view is more widely supported than the other.’

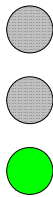

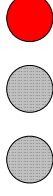
³⁹¹ R. Goode (Chairman) *Pension law reform: the report of the pension law review committee Volume 1: Report and Volume 2: Research* HMSO 1993.

³⁹² This term was used by John Denham, the then Parliamentary Undersecretary at the Department of Social Security, in a speech in 1998, referred to in Scanlan op cit. at 76. Megarry endorsed this principle in his article: ‘Investing Pension Funds: the Mineworkers’ Case’, T.G. Youdan, *Equity, fiduciaries and trusts*, Scarborough, Carswell, 1989 at 158: ‘If other things are equal, it may well be contended that an investment in A Ltd instead of B Ltd, made because the great majority of the beneficiaries oppose investments in B Ltd and so gratifying the majority, will neither harm nor benefit the minority, and so will in general be for the benefit of the beneficiaries at large.’

³⁹³ Pensions Regulator *Guidance from the Pensions Regulator: Guidance for Trustees* <http://www.thepensionsregulator.gov.uk/trustees/guidance/schemeInvestments/invest-02.aspx>.

³⁹⁴ Scanlan, op cit. at 99.

³⁹⁵ Scanlan, op cit. at 98.

Proper application of ESG strategies: UK	
	<ul style="list-style-type: none"> • Select investments with a particular ESG profile as part of building a balanced and properly diversified portfolio • Screen in investments that are expected to yield an attractive return by virtue of their ESG credentials • Screen out investments that are expected to yield a poor return by virtue of their ESG credentials • Screen for investments which, on an analysis of ESG considerations, are thought not to be in the wider interests of the beneficiaries, determined on the basis of conservative assumptions or empirical evidence, and where doing so is reasonably determined to have no or negligible impact on financial returns from the portfolio as a whole • Engage with the companies in which funds are invested (in a targeted and constructive way) on the basis of ESG considerations, with a view to improving the financial performance of the investment or where doing so is in the wider interests of the beneficiaries, determined as above
	<ul style="list-style-type: none"> • Screen for investments on the basis of ESG considerations even where that investment will likely carry a reduced financial return across the portfolio as a whole, provided that doing so is in the wider interests of the beneficiaries as a whole, determined on the basis of conservative assumptions or empirical evidence • Choose one investment from a number of equally attractive investment alternatives on the basis of ESG considerations
	<ul style="list-style-type: none"> • Screen in investments on the basis of ESG considerations even where those investments are expected to result in a significant financial detriment across the portfolio as a whole • Screen for investments on the basis of ESG considerations where doing so unreasonably reduces the diversification of the portfolio • Make investment decisions on the basis of an ulterior motive that overrides the primary purpose of seeking a financial return • Make screening decisions on a whim without properly considering the effect of those decisions or without identifying and weighing all relevant considerations
Some further guiding principles	
<ul style="list-style-type: none"> • Investment decision-makers - whether for a global pension fund or a small charitable trust - should always invest in accordance with a proper financial strategy and should work to well sign-posted investment targets. • In all investment decisions, there must be a constant and real focus on the benefit that will accrue to the beneficiaries from the investment made. • It is always wiser to make a case-by-case decision not to invest in certain products than it is to negatively screen particular investments in advance. As above, it may, however, be possible to operate a limited blacklist of investments. • Seeking sound investment advice from experts for marginal investments to fully understand their financial and social implications is always important. • The law does not prescribe percentages or ratios of ethical investment in a portfolio - this is within the discretion of the investment managers. 	

Engagement

The UK courts have not specifically considered the merits of engagement as part of trustees discharging their fiduciary duties. In the absence of judicial consideration of the issue, it may be argued that, in cases of trusts for financial benefit, such as pension funds, prudent management requires active shareholder engagement to ensure the best possible financial performance.³⁹⁶ Such a view was clearly articulated in the Myners Report:

*If fund managers are truly to fulfil their duty of seeking to maximise value for their shareholders, then there will be times – certainly more than at present – when intervention is the right action to take. ... [E]ffective intervention, when appropriate, is in the best financial interests of beneficiaries. As such, it is arguably already a legal duty of both pension fund trustees and their fund managers to pursue such strategies. US legislative guidance makes it clear that activism – where it might add value – is a part of the fiduciary duty of an investment manager.*³⁹⁷

The Myners Report recommended that all pension fund trustees should incorporate the principle of the US Department of Labor Interpretative Bulletin into fund management mandates (see *Jurisdictional analysis: United States* below). It also recommended that the principle should be more clearly incorporated into UK law. Rather than following this recommendation, the government, in its 2004 review of the Myners Report,³⁹⁸ endorsed the Institutional Shareholders' Committee, *Responsibilities of Institutional Shareholders and Agents – Statement of Principles* (ISC Principles).

The ISC Principles set out best practice for institutional shareholders' interaction with those in whom they invest. The ISC Principles state that:

Institutional shareholders' primary duty is to those on whose behalf they invest, for example, the beneficiaries of a pension scheme or the policyholders in an insurance company, and they must act in their best financial interests. Similarly, agents must act in the best interests of their clients. Effective monitoring will enable institutional shareholders and/or agents to exercise their votes and, where necessary, intervene objectively and in an informed way. Where it would make intervention more effective, they should seek to engage with other shareholders.

Many issues could give rise to concerns about shareholder value. ... Instances when institutional shareholders and/or agents may want to intervene include when they have concerns about ... the company's approach to corporate social responsibility.

It is important also to note the second limb of section 35(3)(f) of the Pensions Act 1995, as amended by the Occupational Pension Schemes (Investment) Regulations 1996. This requires occupational pension trustees to include in their SIP their policy on exercising the rights (including voting rights) attaching to an investment.

For the reasons set out above, we think a court would likely regard shareholder engagement as prudent, provided that it is properly motivated, transparent, informed and objective. Accordingly, targeted and constructive engagement would be acceptable (and in some cases mandatory) where it is aimed at

³⁹⁶ Some commentators believe that more can be achieved by shareholders engaging 'in informal dialogue with company directors to persuade them of the case for change, rather than voting in opposition to management at the annual general meeting'. C Mackenzie, 'Being active is not always about opposition' *Financial Times* (4 July 2005).

³⁹⁷ Paul Myners repeated this position in his *Review of the impediments to voting UK shares: Report to the Shareholder Voting Working Group* January 2004: 'At the heart of our economic and financial system lie quoted companies. One way or another we all have a stake in their success and effectiveness. It is therefore a matter of public interest that the accountability of quoted companies' boards to their shareholders – ultimately ourselves – works efficiently and effectively. That accountability rests on the principle that shares come with voting rights. The stewardship of quoted companies is ultimately exercised through those rights. It cannot be stated too forcefully that institutional investors in the voting process have fiduciary duties to their beneficiaries to preserve and enhance value through informed and effective corporate governance of the companies in which they invest. Voting is the bedrock of governance and should not be approached lightly. The process must be efficient, effective and transparent.'

³⁹⁸ HM Treasury, *Myners principles for institutional investment decision-making: review of progress*, December 2004 (www.hm-treasury.gov.uk/media/DCB/53/myners_principles_web.pdf, accessed 29 July 2005).

improving the financial performance of an investment over the relevant time horizon, for example by encouraging better environmental accountability or more forward-thinking management.

It is more difficult to envision circumstances in which shareholder engagement might be mandated in the absence of a clear link to financial performance (at least in relation to trusts set up for financial purposes). However, as discussed above, there may be circumstances in which the interests of the beneficiaries can be defined broadly to include environmental or social interests and not merely financial performance, and engagement directed at furthering these interests is likely to be acceptable.

8 CONCLUSION

The above discussion has identified that under UK law fiduciary duties provide the limits on investment decision-making that determine the extent to which ESG considerations may be taken into account in the management of institutional investments. Those duties arise only over institutional investments that are structured as trusts, such as pension funds and mutual funds. Institutional investments that are not based on trust structures, such as insurance reserves and non-trust pensions, are not subject to these limits and by law these investment decision-makers are required only to have regard to their duties in negligence and contract.

Where fiduciary duties apply, there is no general requirement in English law or Scots law for investment decision-makers to invest according to ESG considerations but ESG considerations are relevant considerations that must be taken into account in the process of investment decision-making. The weight to be given to ESG considerations, however, is for the investment decision-maker empowered to make discretionary investment decisions in the interests of all the beneficiaries.

Where the purpose of an investment power is to generate returns, a decision-maker must always treat this purpose as the primary objective to be achieved, applying a modern portfolio approach and having regard to the interests of all of the beneficiaries. However, the question is not a zero-sum equation of either maximising returns or favouring ESG issues, but of taking all relevant factors into consideration in a prudent and properly motivated investment analysis. It is not a breach of fiduciary duties per se to have regard to ESG considerations while pursuing the purposes of the trust. Rather, 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. Further, it is also permissible (and in some circumstances mandatory) to integrate ESG considerations where their integration accords with the best interests of the beneficiaries (established via implied or express consensus) or where they act as a point of differentiation among equally attractive investment alternatives.

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- i The simple issue was whether the NUM trustees were in breach of their fiduciary duties in refusing to agree to the new investment plan unless their proposed prohibition on overseas and oil investments was adopted. Sir Robert Megarry said later that he did not consider that he was making new law when he decided the case: R. Megarry, *Investing pension funds: the Mineworkers' case* in T.G. Youdan, *Equity, fiduciaries and trusts*, Scarborough, Carswell, 1989, p115.
- ii Comments made by judges in their judgements on matters not strictly relevant to the dispute being decided are called obiter dicta and are persuasive but not binding on later courts.
- iii The case was not argued by a skilled Chancery barrister but by a layman who is unlikely to have been able to argue the case as well as an experienced advocate. J.H. Farrar and J.K. Maxton suggest 'it is very unfortunate that Mr Scargill and his co-defendants dispensed with their counsel and argued the case on the basis of general ideology rather than particular legal rules. This lack of balanced legal argument undermines the authority of the decision and has led Sir Robert Megarry V-C to formulate principles which are unduly narrow and arguably incomplete': J.H. Farrar & J.K. Maxton, *Social investment and pension scheme trusts*, (1986) 102 LQR 32. The Counsel 'dispensed with' was Leonard Hoffmann QC, a sought-after barrister who became a High Court Judge (where he decided the *Nestle v National Westminster Bank plc (No 2)* case at first instance) and later a Law Lord. Freshfields acted on behalf of the plaintiff trustees.
- iv Trust law is generally argued by specialist Chancery barristers because of its extreme legal technicality.
- v Mr Scargill submitted, for example, that the particular trust scheme in issue 'may be subject to different rules' rather than the well recognised principles of trust law, but did not substantiate that claim with cogent argument: see *Cowan v Scargill* at 516. As Megarry himself put it in subsequent comments on the case: '[o]ne cannot say what would have emerged had the defendants' case been presented by a Chancery [barrister], particularly in the bound and rebound of ideas between Bench and Bar': R. Megarry, *Investing pension funds: the Mineworkers case* in T.G. Youdan, *Equity, fiduciaries and trusts*, Scarborough, Carswell, 1989, p. 149.
- vi The only English authority on pension funds that was before Megarry was *Evans v London Cooperative Society Ltd* *The Times* (July 9, 1976), which went only to the question whether the ordinary law of trusts applied to pensions: Megarry, *op. cit.*, p. 155. In Megarry's view, the case 'probably ... would have attracted little attention if the territory that it covered had been occupied by a reasonable body of authority; but in England the cupboard was bare'.
- vii The judgment was clearly influenced by the NUM Trustees' adoption of union policy, rather than turning their own minds to whether the investment plan was in fact in the interests of the beneficiaries.
- viii The rationale for the NUM prohibition was that 'if all, or nearly all, of [the assets of British pension funds] were invested in Britain ... this would do much to revive this country's economy and so benefit all workers': *Cowan v Scargill* at 521. This motive of 'propping up' an industry in which only some beneficiaries have a clear interest is obviously problematic.
- ix As Megarry put it: 'many of the actual or potential beneficiaries were obviously concerned with the well-being of the coal mining industry; but there were others, especially some of the widows and orphans, who were not, and, indeed, may have wished it ill': Megarry, *op. cit.*, p. 153. It is well settled that the interests of the beneficiaries as a whole must be considered, rather than the interests of any particular class.
- x Scargill claimed that the NUM trustees had legal advice to support their position but Megarry considered that to be untrue: Megarry, *op. cit.*, p.153.
- xi The NUM Trustees were not prepared to accept anything other than a complete embargo on overseas and coal-competing investments. Therefore, the case did not consider the propriety of nuanced 'preference' policies, involving balancing or judgement on the part of the trustees or their agents. The outcome of the case may have been different had they sought merely to impose a limit on the proportion of such investments as part of the trust portfolio or made some other concession.
- xii It has been suggested that 'it is almost ... inconceivable ... that scheme trustees or their investment consultants and fund managers would contemplate adopting an SRI policy which possessed any of the ... features [of the NUM plan]': Scanlan, *op. cit.*, p. 104.
- xiii There have been dramatic changes in the scale and spread of occupational pensions and the investment methodologies applied to them in the period since the case was decided. The regulatory context has also changed in that, most notably, the Pensions Act 1995 now requires pension funds to publish a SIP detailing their policy in relation to the consideration of ESG issues. Megarry himself has recognised that concrete rules applicable to investment decision-making must be altered where this is necessary to keep up with changes in investment practice: in another case decided in the same year as *Cowan v Scargill*, he held that cases decided 20 years previously should no longer be regarded as binding in the face of greatly changed commercial conditions: *Trustees of the British Museum v Attorney General* [1984] 1 WLR 418. For a similar statement of this principle for pension schemes, see *Re Courage* at 536.
- xiv The pension scheme was not an ordinary private trust but had been set up under a scheme for nationalisation, the object of which was to develop the coal industry. As has been pointed out, Megarry made no mention of this feature of the fund in his judgment: Farrar & Maxton, *op. cit.*, p. 33.
- xv As Yaron points out, the judgment 'entirely ignored the highly charged political context at the time between the Thatcher Government and the miner's union' Yaron, 2005, *op. cit.*, p. 14.

1 INSTITUTIONAL INVESTMENT

Pension funds (private and public), insurance companies, mutual funds, charitable trusts and non-profit corporations (collectively “institutional investors”) are vitally important players in the US investment landscape.³⁹⁹

Given the variety of different federal and state law which regulates the investment behaviour of these different institutional entities, any summary of the relevant US law necessarily involves generalisation. Nevertheless, there are definite and identifiable trends in the legal framework and commercial practice of ESG investment in the US. The most significant trend is the development of the modern prudent investor rule, achieved through federal statutes, state statutes implementing uniform laws and the development of state common law with reference to the American Law Institute’s *Restatement (Third) of Trusts: Prudent Investor Rule*. The modern prudent investor rule emphasises modern portfolio theory and requires that:

- investments be assessed not in isolation but in the context of their contribution to a total investment portfolio;
- the investment portfolio be diversified, unless it is prudent not to do so; and
- the prudence of an investment should be assessed at the time the investment is made and not in hindsight.

The effect of the modern prudent investor rule is that institutional decision-makers are given latitude to follow a wide range of diversified investment strategies, provided their choice of investments is rational and economically defensible. Investments must, however, always be made for the purposes of the fund and/or for the benefit of the fund’s beneficiaries.⁴⁰⁰

This latitude can be seen in practice, as there is a significant volume of institutional investment in the US that already takes account of ESG considerations in portfolio investment plans.⁴⁰¹

The legal regimes applicable to the different institutional investors are briefly explained below.

Pension funds

US pension funds may be private or public. Private pension funds are governed under federal law by the Employee Retirement Income Security Act 1974 (ERISA). This law is administered and enforced by the US Department of Labor.⁴⁰² Public funds, established for the benefit of public employees, are governed by state laws. In most states, such as Connecticut, the governing rules are established by statute. In other states, such as California, the source of law is both statutory and constitutional. In

³⁹⁹ In 2004, US insurers and pensions funds owned 69.4 per cent of the equity of the largest 1,000 US companies, up from 61.4 per cent in 2000. In 2003, US institutional investors controlled US\$19.634 trillion in assets. See The Conference Board, *Institutional Investment Report 2005: U.S. and International Trends - Report 1376*, September 2005 (available at <http://www.conference-board.org>).

⁴⁰⁰ In this regard, it should be noted that the academic debate over the precise role of ESG considerations in investment decisions has not died away. See eg, articles cited *infra*.

⁴⁰¹ See eg Michael Kroll, *Ethical Screening in Modern Financial Markets: the Conflicting Claims Underlying Socially Responsible Investment*, 57 Bus. Law. 681 (2002); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 Colum. L. Rev. 795 (1993); and Deborah Martin, *The Public Piggy Bank Goes to Market: Public Pension Fund Investment in Common Stock and Fund Trustees’ Social Agenda*, 29 San Diego L. Rev. 39 (1992). In 2003, 11.6% of all institutional investment was made by traditionally “activist” public employee pension funds. See Conference Board Report, *op cit*.

⁴⁰² Note that, in some cases, other federal legislation may be relevant for pension plans excluded from ERISA. For instance, the US Investment Company Act 1940, 15 USC § 80(a) *et seq* contains certain rules, broadly equivalent to ERISA, for church employee pension plans: see 15 USC §80(a)-3(c), as amended by the National Securities Market Improvement Act 1996, § 508. Church plans are excluded from ERISA: see 29 USC § 1003(b)(2).

addition, 43 states plus Washington D.C. have adopted the Uniform Prudent Investor Act (UPIA), which implements the modern prudent investor rule and, where adopted, applies to public pension trusts.⁴⁰³

Mutual funds

Mutual funds are corporations or business trusts governed under state law and required to be administered for the benefit of their shareholders. They are also subject to the Investment Company Act of 1940⁴⁰⁴ and therefore fall under the jurisdiction of the Securities and Exchange Commission (SEC). The Investment Company Act circumscribes the proper investments of ‘investment companies’ by prohibiting certain speculative investments, such as the purchase of securities on margin or securities of unregistered companies.⁴⁰⁵

Insurance companies

Insurance corporations are the product of state law.⁴⁰⁶ While laws vary from state to state, it is generally true that investment options for insurance companies are highly controlled and limited by state regulations.⁴⁰⁷ Most regulations are based on ensuring the integrity of the insurer’s loss reserves. Therefore, most investments must be conservative (eg government bonds) so that the insurer will have an appropriate amount of liquidity. Subject to these specific state regulations, insurance companies (not being trusts) otherwise retain flexibility in their investment choices at common law.

Non-profit corporations

The law applying to non-profit corporations is state law (often a separate but similar statute to the state’s corporations law). In many states, the investment powers of non-profit corporations are modified by the state’s adoption of a statute based on the Uniform Management of Institutional Funds Act (UMIFA), which applies a standard of care analogous to the business judgment rule (defined below) to investment powers for eleemosynary (or non-profit) institutions.⁴⁰⁸

Private trusts

These are also regulated by state law. UPIA, to the extent it has been adopted in each state, contains the basic rules on trustee investment, supplemented by the state’s common law – which is informed by the principles developed in the *Restatement (Third) of Trusts: Prudent Investor Rule*.

Charitable trusts

Charitable trusts are generally subject to the same common law rules in each state as private trusts.⁴⁰⁹ In many states, the investment powers of charitable trusts are modified by the state’s adoption of a statute based on UMIFA.

⁴⁰³ See ULA: Prudent Investor Act, Refs. & Annos., Table of Jurisdictions. Most of the remaining states have adopted non-uniform variations of UPIA: see John Langbein, *Questioning the Trust Duty of Loyalty: Sole Interest of Best Interest?*, 114 Yale L.J. 929, 969 (2005).

⁴⁰⁴ See generally 15 USC § 80(a) *et seq.* Mutual funds, however organised, are ‘investment companies’ for the purposes of the federal laws. An investment company is defined as any issuer that ‘is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities’: ICA § 3; 15 USC § 80(a)-3.

⁴⁰⁵ See ICA § 12; 15 USC § 80(a)-12.

⁴⁰⁶ The federal McCarran-Ferguson Act (15 USC § 1011 *et seq.*) provides that state law controls the ‘business of insurance’. Accordingly, only federal non-insurance business laws (eg tax, labour, antitrust, securities, and discrimination) apply to insurance companies.

⁴⁰⁷ See eg, Cal. Ins. Code §§ 1170 – 1182; and Florida Ins. Code §§ 625.301 - 625.340. Both are annexed.

⁴⁰⁸ See UMIFA § 6.

⁴⁰⁹ *Restatement (Second) of Trusts* § 389 (1959). See also UPIA, prefatory note, 3.

	Relevant federal law	Relevant state law
Private pension fund	ERISA (which absorbs common law trust standards as reflected in UPIA and the Third Restatement) – see below.	N/A
Public pension fund	N/A	State constitutions and statutes. UPIA if adopted; Third Restatement as reflected in state common law.
Mutual fund	SEC regulation generally. ERISA (to the extent providing an employee benefit plan only).	If a trust, UPIA if adopted; Third Restatement as reflected in state common law. If a corporation, state corporate law including duty of care and business judgement rule.
Insurance company	ERISA (to the extent providing an employee benefit plan only).	State regulation providing for secure reserves. State corporate law including duty of care and business judgement rule.
Non-profit corporation	N/A	UMIFA if adopted; if not, state corporate law including duty of care and business judgement rule.
Private trust	N/A	UPIA if adopted; Third Restatement as reflected in state common law.
Charitable trust	N/A	UMIFA if adopted; Third Restatement as reflected in state common law.

2 LEGAL CONTEXT FOR INVESTMENT DECISION-MAKING

Aside from the federal regulation of mutual funds and any specific state regulation of insurance companies outlined above, the main restrictions in the US on the investment freedom of institutional investors are the applicable fiduciary duties. Although the legal frameworks are diverse, the common denominator is that fiduciary duties apply to most of the participants of the different US institutional investment funds. The content of these duties varies according to the specific jurisdictions and applicable laws, but is informed by a general and well-established body of jurisprudence, which is summarised in this report.⁴¹⁰

As a generalisation, three types of regulatory framework apply to the different investors.

- Non-charitable trusts (including private and public pension funds and mutual funds organised as trusts) are directly subject to the modern prudent investor rule through a range of different mechanisms.
- Charitable trusts are, at common law, also subject to the modern prudent investor rule, but its operation in respect of charitable trusts is somewhat attenuated. In many jurisdictions, the adoption of UMIFA has supplanted the application of the prudent investor rule by applying the business judgement rule to investment decisions.
- Corporations (including insurance companies and mutual funds organised as corporations) are not generally subject to the modern prudent investor rule (unless it has been extended to them by statute),⁴¹¹ but under both common law and statute directors owe duties of both loyalty and care.⁴¹² The decisions of company directors are, however, usually subject to the business judgement rule.⁴¹³

⁴¹⁰ This report does not purport to explain the legal regime of every US state, but seeks to extract the main themes and features of US legal regulation of institutional investment.

⁴¹¹ Note that some jurisdictions regard directors of non-profit corporations as akin to trustees – in which case they will be subject to the modern prudent investor rule.

⁴¹² The latter of which generally requires directors to act with that diligence, care, judgement and skill that ordinary prudent men would exercise under similar circumstances in like positions. See eg 3A *Fletcher*

Key terms

The *modern prudent investor rule* redefines the standard of prudent investment to (a) include the duty of loyalty and the duty to diversify investments; and (b) determine the prudence of an investment, at the time it was made, using modern portfolio theory. Therefore, investments are not assessed individually, but only in the context of their contribution to the overall portfolio.

Modern portfolio theory is an economic theory developed by Harry Markowitz in 1953, which argues that investors should focus on selecting diversified portfolios based on their overall risk-reward characteristics instead of merely compiling portfolios from securities that each individually have attractive risk-reward characteristics. That is, investors should select portfolios not individual securities.

The *business judgement rule* provides that a court will not second-guess a business decision (including an investment decision) unless it is made in bad faith, involves self-dealing or is grossly negligent.

The modern prudent investor rule

The genesis of the prudent investor rule is usually dated back to an 1830 Massachusetts case, which held that trustees should ‘observe how men of prudence, discretion and intelligence manage their own affairs, not only in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable outcome, as well as the probable safety of the capital to be invested’.⁴¹⁴

This standard, which is not very different to the duty of care now owed by company directors, was codified by the 1942 Model Prudent Man Statute, which inspired many state statutes. Over time, as case law clarified the prudent man standard, the rule was perceived to lose much of its original flexibility and fell out of step with modern investment practice.⁴¹⁵

In recent years, the prudent investor rule has undergone two important revisions. First, it has been merged with other duties applicable to trustees, such as loyalty and diversification. Second, it has been updated to embrace modern portfolio theory.

Cyclopaedia of the Law of Private Corporations § 1036. Note that the duty of loyalty for corporations does not limit directors to considering only the tangible balance sheet implications of decisions: see 18A Am. Jur. 2d Corporations §1711 (1985).

⁴¹³ In addition, non-profit corporations are sometimes the subject of the business judgement rule through a statute based on UMIFA.

⁴¹⁴ *Harvard College v Amory*, 26 Mass. (9 Pick.) 446 (1830).

⁴¹⁵ See eg Edward C. Halbach, *Significant Trends in the Trust Law of the United States*, 32 Vand. J. Transnat'l L. 531, pp. 544-545. Not every state has adopted the modern prudent investor rule. A few states, such as Alabama, West Virginia and Kentucky, continue to impose more restrictive statutory rules governing trust investments: see Restatement (Third) of Trusts: P.I.R. § 228 (1992), comment d.

This first development can be seen in ERISA, which defines the ‘prudent man standard of care’ as follows:⁴¹⁶

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 familiar with such matters 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 minimise 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.

Thus, the traditional prudence standard (included as sub-para B)⁴¹⁷ was supplemented with a duty of loyalty (sub-para A), a duty to diversify (sub-para C) and a duty to act according to the plan instruments (sub-para D). The merging of the duties of prudence and loyalty has been explained as follows:⁴¹⁸

‘The concept that the duty of prudence in trust administration, especially in investing and managing trust assets, entails adherence to the duty of loyalty is familiar. ERISA § 404(a)(1)(B)...effectively merges the requirements of prudence and loyalty. A fiduciary cannot be prudent in the conduct of investment functions if the fiduciary is sacrificing the interests of beneficiaries.’

The second development was a product of the decade of trust reform undertaken in the 1990s. To begin with, the prudent investor portion of the *Restatement (Second) of Trusts* was revised in 1992.⁴¹⁹ UPIA was promulgated in 1994 and has now been adopted in 43 states, plus Washington D.C.⁴²⁰ Both of these developments update the prudent investor rule to give effect to the modern portfolio theory of investment.

⁴¹⁶ ERISA § 404(a); 29 USC § 1104(a).

⁴¹⁷ Note that the duty of care is relative to the trustee’s own level of skill and expertise: *Restatement (Second) of Trusts* § 174 (1959). Thus, professional investment trustees are held to higher standards of conduct than trustees of ordinary investment skills.

⁴¹⁸ Uniform Prudent Investor Act, comment to § 5.

⁴¹⁹ *Restatement (Third) of Trusts: P.I.R.* § 227 (1992). A Restatement is not a primary source of law. It is an authoritative attempt of the American Law Institute at codifying and updating the common law of the different US jurisdictions, usually led by an acknowledged authority in the field (in this case the Reporter was Professor Edward Halbach). Although not binding, Restatements are very influential, particularly in evolving areas of law.

⁴²⁰ ULA: Prudent Investor Act, *op cit*. A Uniform Law is a model statute prepared by the United States National Conference of Law Commissioners and then made available to US states to adopt (with changes, if desired). Where a Uniform Law has been widely adopted, as with UPIA, reference to the Uniform Law is a good way to broadly summarise the laws of different states. Note that a new Uniform Trust Code was prepared in 2000 to incorporate UPIA as article 9. This code has not yet been widely adopted.

Section 227 of the *Restatement (Third) of Trusts: Prudent Investor Rule* provides:

Restatement (Third) of Trusts: P.I.R., §227: General standard of prudent investment
<p>The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust.</p> <p>(a) This standard requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.</p> <p>(b) In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.</p> <p>(c) In addition, the trustee must:</p> <ul style="list-style-type: none">(i) conform to fundamental fiduciary duties of loyalty and impartiality;(ii) act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents; and(iii) incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship. <p>(d) The trustee's duties under this Section are subject to the rule of §228, dealing primarily with contrary investment provisions of a trust or statute.</p>

This approach is reflected in UPIA, §§ 2, 3 and 5. The objectives of UPIA are stated in its prefatory note and are set out below.

UPIA, Prefatory Note: Objectives of the Act
<p>UPIA makes five fundamental alterations in the former criteria for prudent investing. All are to be found in the Restatement of Trusts 3d: Prudent Investor Rule.</p> <ul style="list-style-type: none">• The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In the trust setting, the term 'portfolio' embraces all the trust's assets.• The trade-off in all investing between risk and return is identified as the fiduciary's central consideration.• All categorical restrictions on types of investments have been abrogated; the trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing.• The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing.• The much criticised former rule of trust law forbidding the trustee to delegate investment and management functions has been reversed. Delegation is now permitted, subject to safeguards.

Delegation powers

One of the important aspects of the modern prudent investor rule is that it specifically addresses, and permits, significant delegation. The reasoning behind this is that modern trustees of major funds should be expected to utilise the services of fund managers and investment consultants in performing their investment powers.⁴²¹

ERISA explicitly permits a pension or employee benefit plan to provide that 'authority to manage, acquire or dispose of assets of the plan is delegated to one or more investment managers'.⁴²² ERISA also explicitly addresses the consequences of this delegation power. Fiduciary liability attaches not only to the trustee,⁴²³ but also to all persons who exercise discretion over plan assets (who are

⁴²¹ John H. Langbein, *Tribute to William F Fratcher: Reversing the Nondelegation Rule of Trust-Investment Law*, 59 Mo. L. Rev. 105, pp. 113-114 (1994).

‘functional’ fiduciaries, to the extent of their discretion).⁴²⁴ Fund managers are specifically regarded as fiduciaries.⁴²⁵ The appointment of fiduciaries is itself a fiduciary function, and federal courts have imposed liability where ERISA trustees have been derelict in selecting and monitoring agents.⁴²⁶

The *Third Restatement* also contains a broad delegation rule, which requires the trustee to ‘act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents.’⁴²⁷ The comments to the *Third Restatement* suggest that a trustee will sometimes have a duty to delegate investment functions in such manner as a prudent investor would delegate under the circumstances.⁴²⁸ A similar approach is followed in UPIA, which also details the consequences of delegation.⁴²⁹ In short, the trustee is liable for failing to (a) properly select an agent, (b) establish the scope and terms of the delegation consistent with the purposes and terms of the trust, or (c) periodically monitor the agent’s performance. The agent, who is not itself a fiduciary, has a duty to the trust to exercise reasonable care to comply with the terms of the delegation. The trustee is not liable for the decisions or actions of the agent.⁴³⁰

Note that important federal legislation, including the US Investment Advisors Act 1940,⁴³¹ the US Investment Company Act 1940⁴³² and the National Securities Market Improvement Act 1996,⁴³³ also adds layers of duties specifically directed to fund managers and investment consultants. Although none of these Acts expressly designates investment advisers as fiduciaries, this result is said to arise inherently out of the nature of the relationship between the investment adviser and client.⁴³⁴

⁴²² ERISA § 403(a)(2), 29 USC § 1103.

⁴²³ Each ERISA plan must designate at least one fiduciary, who is usually the plan trustee: ERISA, § 402(a), 29 USC § 1102(a).

⁴²⁴ ERISA § 3(21), 29 USC § 1002(21). Note that there are split circuit views on when individual officers of corporate trustees will themselves be fiduciaries under 29 USC § 1002(21). The Ninth Circuit has held that where a corporation is named as the plan trustee under ERISA, the administrating officers are themselves fiduciaries: see *Stewart v. Thorpe Holding Co. Profit Sharing Plan*, 207 F.3d 1143 (9th Cir. 2000). The Third Circuit has held that the administrating officers will only be fiduciaries if the corporation has delegated its fiduciary powers to them (either expressly or implicitly): see *Confer v. Custom Engineering Co.*, 952 F.2d 34 (3d Cir. 1991).

⁴²⁵ ERISA § 3(38), 29 USC § 1002(38) and must acknowledge their fiduciary status in writing. See *Lowen v Tower Asset Management*, 829 F.2d 1209, 1218 (2d Cir. 1987).

⁴²⁶ 29 C.F.R. § 2509.75-8 at D-4.

⁴²⁷ *Restatement (Third) of Trusts: P.I.R.* § 227.

⁴²⁸ *Restatement (Third) of Trusts: P.I.R.* § 227, comment j.

⁴²⁹ UPIA, § 9.

⁴³⁰ A similar rule exists in UMIFA for charitable trusts: see UMIFA, § 5.

⁴³¹ 15 USC § 80(b) *et seq.*

⁴³² 15 USC § 80(a) *et seq.*

⁴³³ 15 USC 78a *et seq.*

⁴³⁴ See John Cacchione, *US Approach to Fiduciary Duties: General Law, the Investment Advisors Act, the Investment Company Act and ERISA*, cited in Dick Frase (ed) *Law and Regulation of Investment Management* (2004), 268. These Acts, enforced by the SEC, hold investment advisers to standards of good faith and skill in the execution of their investment functions and contain numerous specific regulatory requirements. For more detail, see also Michael McDonough and Maureen Magner, *US Regulation of Investment Management*, in *Law and Regulation, ibid.*

The business judgement rule

Under the common law business judgement rule, a court will not second-guess a business decision so long as the decision-maker exercised a minimum level of care in arriving at the decision.⁴³⁵ Effectively, the rule requires only that decisions are made in good faith and are not grossly negligent.⁴³⁶

As stated above, the business judgement rule applies to decisions taken by directors of corporations (usually including non-profit corporations, unless the directors are regarded as akin to trustees).⁴³⁷ UMIFA expressly applies the business judgement rule to investment decisions by non-profit corporations, foundations, charitable trusts and governing boards of other eleemosynary institutions.⁴³⁸

Accordingly, even though company directors are subject to a duty of care through state law (and charitable trusts are subject to the modern portfolio investment rule), where the business judgement rule applies, significant latitude is given to all business decisions taken, including investment decisions. Liability will only attach for bad faith or gross negligence. The business judgment rule is usually not applied so as to protect breaches of the duty of loyalty owed to the company.⁴³⁹

3 INTEGRATION OF ESG CONSIDERATIONS INTO INVESTMENT DECISION-MAKING

There is an ongoing debate in the US regarding whether applying ESG considerations to an investment decision violates the modern prudent investor rule. This part examines the role of ESG considerations under ERISA, the Third Restatement and UPIA. It should be noted that, although different, these authorities are generally compatible and cross-fertilise.⁴⁴⁰ It is accordingly sensible to consider the place of ESG considerations by examining them together.

The short conclusion is that ESG considerations may be taken into account as long as they are motivated by proper purposes and do not adversely affect the financial performance of the entire portfolio. There are few US cases on point, but the cases that do exist generally support the use of ESG considerations within the context of a proper investment strategy.

⁴³⁵ See Revised Model Business Corporation Act § 8.30 (1984). See, eg *In re Bal Harbour Club, Inc.*, 316 F.3d 1192 (11th Cir. 2003) and *Katz v Chevron Corp.*, 22 Cal App 4th 1352 (1994).

⁴³⁶ L. Solomon & K. Coe, *Social Investments by Non-profit Corporations and Charitable Trusts: A Legal and Business Primer for Foundation Managers and Other Non-profit Fiduciaries*, 66 UMKC L. Rev. 213 (1997).

⁴³⁷ See *Louisiana World Exposition v Federal Insurance Company*, 864 F.2d 1147 (5th Cir. 1989). But see *Stern v Lucy Webb Hayes Nat. Training Sch. for Deaconesses and Missionaries*, 381 F.Supp. 1003 (D.D.C. 1974).

⁴³⁸ UMIFA, § 6. Note of course that individual states that have adopted UMIFA may have altered its scope to exclude certain eleemosynary institutions.

⁴³⁹ See, eg, *In re The Walt Disney Company Derivative Litigation*, No. 15452 (Del. Ch. Aug. 9, 2005). See also Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. Rev. 733 (2005), which argues that “[u]nder the business judgment rule, the courts won’t second-guess managers’ business judgment about what conduct is in the best interests of the corporation unless those managers have a conflict of interest” which Elhauge states is limited by statutes and case law to “the financial interests of the director and his immediate familiar and associates”, at 770.

⁴⁴⁰ See *Restatement (Third) of Trusts: P.I.R.* § 227, general comment: ‘The principles of this Section are generally appropriate to those statutory rules [including ERISA], both by analogy and where those rules incorporate general principles of trust law.’ See also *Firestone Tire & Rubber Co v Bruch*, 489 U.S. 101, 110-111 (1989): ‘ERISA’s legislative history confirms that the Act’s fiduciary responsibility provisions ‘codif[y] and mak[e] applicable to [ERISA] fiduciaries certain principles developed in the evolution of the law of trusts’. Also, note that UPIA was explicitly based on the revised standards contained in the Third Restatement of Trusts (P.I.R.): see prefatory note, 1. ERISA is, however, sometimes taken to impose a stricter standard than the common law: see *Eaves v Penn*, 587 F.2d 453, 457 (10th Cir. 1978).

The modern prudent investor rule and ESG considerations

- Modern portfolio theory is now the standard, meaning trustees have a very wide discretion in selecting investment strategy, having respect to risk and return objectives suitable to the trust.
- This means that there is no duty to ‘maximise’ the return of each individual investment, but instead a duty to implement an overall investment strategy that is rational and appropriate to the fund.
- Diversification is required (though there is no duty to maximally diversify – thus negative screening is not prohibited per se).
- ESG considerations may be taken into account so long as they do not adversely affect the formulation or performance of the entire portfolio (eg, by making it unbalanced, improperly diversified, unable to meet the suitable risk and return objectives).
- ESG considerations may not be acted on purely to give effect to the personal views of the decision-makers.
- All investments must be assessed at the time of investment, not in hindsight.

ERISA

ERISA contains an express duty of loyalty⁴⁴¹ which some commentators regard as inconsistent with the use of ESG considerations in making investment decisions.⁴⁴²

The US Department of Labor has, however, endorsed modern portfolio theory⁴⁴³ and has taken a formal position on ERISA that does not rule out the consideration of ESG issues.⁴⁴⁴ The Department considers that ERISA’s fiduciary duties:⁴⁴⁵

‘do not preclude consideration of collateral benefits, such as those offered by a ‘socially-responsible’ fund, in a fiduciary’s evaluation of a particular investment opportunity. However, the existence of such collateral benefits may be decisive only if the fiduciary determines that the investment offering the collateral benefits is expected to provide an investment return commensurate to alternative investments having similar risks.’

This passage is somewhat ambiguous as it is open to the interpretation that – notwithstanding the Department’s early endorsement of modern portfolio theory – investment decisions might still be evaluated on an investment-by-investment basis. Case law under ERISA has (perhaps surprisingly) not expressly considered this issue – although it has generally supported the view that investments should be evaluated in the context of their role in a portfolio and that investments which are reasonable and supported by proper planning, advice and objectives will not be second-guessed merely because, in hindsight, they are not the most profitable investments that could have been made.⁴⁴⁶ Accordingly, in

⁴⁴¹ ERISA, §404(a)(1)(A); 29 USC § 1104(a)(1)(A).

⁴⁴² See eg, John H. Langbein & Richard Posner, *Social Investing and the Law of Trusts*, 79 Mich. L. Rev. 72 (1980); John H. Langbein & Bruce A. Wolk, *Pension and Employee Benefit Law* 841-852 (3rd ed. 2000); and Ian D. Lanoff, *The Social Investment of Private Pension Plan Assets: May It Be Done Lawfully Under ERISA?*, 31 Labor L.J. 387 (1980). Other commentators have disagreed with this interpretation. See eg, R. Ravinoff & M. Curzan, *Social Responsibility in Investment Policy and the Prudent Man Rule*, 68 Cal. L. Rev. 518 (1980); Marcia O’Brien Hutton, *Socially Responsible Investing: Doing Good Versus Doing Well in an Inefficient Market*, 42 Am. U. L. Rev. 1 (1992); E. Adams & K. Knutsen *A Charitable Corporate Giving Justification for the Socially Responsible Investment of Pension Funds: A Populist Argument for the Public Use of Private Wealth*, 80 Iowa L.Rev. 221 (1995); and Angela Read, *Building Signposts for the Future: Investment Strategy, Socially Responsible Investing, and ERISA*, 23 J. Pension Plann’g & Compl. 39 (1997).

⁴⁴³ See the preamble to the regulation under ERISA promulgated by the Department of Labor at 44 Federal Register 37255 (July 23, 1979).

⁴⁴⁴ See the Department of Labor’s Interpretative Bulletin relating to the fiduciary standard under ERISA in considering economically targeted investments – that is, investments selected for the economic benefits they create apart from their investment return to the employee benefit plan, 29 C.F.R. § 2509.94-1 (23 June 1994); and regulation 29 C.F.R. § 2550.404a-1, which considers the investment duties of trustees under ERISA.

⁴⁴⁵ See Letter from the Department of Labor to William M. Tartikoff, Senior Vice President and General Counsel of Calvert Group Ltd. (May 28, 1998) (Calvert Letter).

⁴⁴⁶ See, eg *In re Enron Corporation Securities, Derivative and ERISA Litigation*, 284 F.Supp.2d 511 (S.D.Tex. 2003); and *Donovan v Cunningham*, 716 F.2d 1455 (5th Cir. 1983).

one case, a Florida district court held that union pension plan trustees did not breach their fiduciary duties by investing in real estate into which a union-affiliated organisation became a tenant.⁴⁴⁷ Although the investment turned out to be improvident, it was carefully considered at the time and the trustees' behaviour was reasonable.⁴⁴⁸

The closest authority on point is a Maryland Court of Appeals decision that did not consider ERISA directly, but the Baltimore City Code, which contained substantially identical language to the ERISA prudent investor standard.⁴⁴⁹ In this case, the Baltimore City Council passed ordinances that prohibited the three city employee pension schemes from investing (and required them to divest all existing investments) in then-apartheid South Africa. The trustees of the schemes argued that the ordinances conflicted with the trustees' fiduciary duties as expressed in the Baltimore City Code and were accordingly illegal.⁴⁵⁰

The Court of Appeals disagreed and held that, under the modern prudent investor rule, a trustee is not required to maximise the return on investments but rather to secure a 'just' or 'reasonable' return while avoiding undue risk.⁴⁵¹ Accordingly, if social investment yields economically competitive returns at a comparative level of risk, the investment is prudent.⁴⁵² The court further stated that where the costs of considering the social consequences of investment decisions are *de minimis*, a trustee will ordinarily not have transgressed the duty of loyalty (or any other applicable duty) by doing so.⁴⁵³

Restatement(Third) of Trusts: Prudent Investor Rule

The *Third Restatement* makes it clear that the adoption of modern portfolio theory has caused a revolution in the assessment of trustee prudence. Under § 227, no particular type of investment is impermissible in the abstract.⁴⁵⁴ All assessments of prudence must be made 'within the context of the trust's portfolio and purpose'⁴⁵⁵ and 'as of the time the investment decision was made, not with the benefit of hindsight'.⁴⁵⁶

This gives trustees very significant flexibility to fashion appropriate investment strategies for their particular fund. This requires skill and care in terms of formulating and implementing the strategy,

⁴⁴⁷ *Donovan v Walton*, 609 F. Supp. 1221 (S.D.Fla. 1985). See also *Donovan v Bierwith*, 680 F.2d 263 (2d Cir. 1982), in which the court held that incidental benefits to trustees and the company did not breach ERISA, provided the trustees had reasonably concluded that the action taken was the best course to promote the interests of participants and beneficiaries. Note too that John Langbein, Reporter for UPIA and co-author in 1980 (with Richard Posner) of the leading article opposing social investment, this year wrote an article arguing that the duty of loyalty generally should be revised or interpreted so as to allow trustees to achieve incidental benefits for themselves or third parties, while still acting in the best interests of the beneficiaries: *Questioning the Trust Duty of Loyalty: Sole Interest or Best Interest?*, 114 Yale L.J. 929 (2005).

⁴⁴⁸ *Ibid*, 1241. In a related case, the Eleventh Circuit held that an ERISA requirement that trustees charge a 'reasonable rate' of interest on loans to pension plan employees did not necessarily mean the prevailing or market rate, and could be below this. See *Brock v Walton*, 794 F.2d 586 (11th Cir. 1986).

⁴⁴⁹ *Bd. of Trustees v Mayor of Baltimore City*, 317 Md. 72, 562 A.2d 720 (1989), *cert. den. sub nom. Lubman v. Baltimore City*, 493 U.S. 1093.

⁴⁵⁰ The main ground of this argument was that the ordinances conflicted with the Baltimore City Code, which provided the terms of the pension contracts, and thus constituted an unconstitutional interference with contracts.

⁴⁵¹ *Ibid*, at 108.

⁴⁵² *Ibid*, at 108.

⁴⁵³ *Ibid*, at 109-110.

⁴⁵⁴ *Restatement (Third) of Trusts: P.I.R.* § 227, comment k.

⁴⁵⁵ *Ibid*, comment k. See also comment on prudent investing: 'The riskiness of a specific property, and thus the propriety of its inclusion in the trust estate, is not judged in the abstract but in terms of its anticipated effect on the particular trust's portfolio'.

⁴⁵⁶ *Ibid*, general comment.

selecting the investment portfolio with regard to the expected levels of return and risk, and monitoring the performance of the strategy.

The duty of diversification is central to the modern rule. The *Third Restatement* comments are careful to note that there is no defined set of asset categories to be considered by fiduciary investors: ‘[n]or does a trustee’s general duty to diversify investments assume that all basic categories are to be represented in a trust’s portfolio...[s]ignificant diversification can be achieved with a small number of well-selected securities representing different industries and having other differences in their qualities’.⁴⁵⁷ This approach is irreconcilable with the profit-maximisation approach said to be adopted by, for instance, the English authority of *Cowan v Scargill*. There is no duty to obtain the greatest possible return on each investment,⁴⁵⁸ nor even to beat the indexes and obtain the greatest possible portfolio return. The duty is to formulate and implement an investment strategy that incorporates risk and return objectives ‘reasonably suitable to the trust’, over the entire trust portfolio, in light of the trust’s funding requirements, risk tolerance and purpose.

The comments to the *Third Restatement* expressly consider the topic of social investing and state the following:⁴⁵⁹

‘The [duty of loyalty] also applies to investing in a manner that is intended to serve interests other than those of the beneficiaries or the purposes of the settler. Thus, for example, in managing the investments of a trust, the trustee’s decisions ordinarily must not be motivated by a purpose of advancing or expressing the trustee’s personal views concerning social or political issues or causes. Such considerations, however, may properly influence the investment decisions of a trustee to the extent permitted by the terms of the trust or by the consent of the beneficiaries.’

This is consistent with the view that ESG considerations may be taken into account in formulating and implementing an investment plan – but not to advance or express the trustee’s own personal views.⁴⁶⁰

The comments go on to state that charitable trusts may take social considerations into account ‘to the extent the charitable purposes would justify an expenditure of trust funds for the social issue or cause in question or to the extent the investment decision can be justified on grounds of advancing, financially or operationally, a charitable activity conducted by the trust.’⁴⁶¹

⁴⁵⁷ *Ibid*, comment g.

⁴⁵⁸ Note that in one recent case, *Marshall v First National Bank, Alaska*, 97 P.3d 830 (2004), the Alaskan Supreme Court held that ‘a trustee has a duty to invest so as to obtain the largest possible return consistent with the principal’s safety’ (at 839). This proposition was supported only by a reference to a US legal encyclopaedia, which – on review – does not support the proposition at all. In our view, the proposition is unsound and unsupported by authority.

⁴⁵⁹ *Ibid*, comment c. See also *Restatement (Third) of Trusts (Tentative Draft)* § 78 (Duty of Loyalty) which, under comment f, continues to reflect this view – whilst noting that “considerable disagreement continues about what loyalty should require in [the social investment] context”.

⁴⁶⁰ The leading case sometimes cited to the contrary, *Blankenship v Boyle*, 329 F. Supp. 1089 (D.D.C. 1971), held that welfare fund trustees, who were also union members, breached their duty of loyalty by investing in stocks that gave a direct benefit to their union. This case therefore concerned a direct conflict of interest. In any event, the case was decided many years before the development of the modern prudent investor rule. *Blankenship* was distinguished in this way in *Withers v Teachers’ Retirement System of the City of N.Y.*, 447 F.Supp. 1248 (S.D.N.Y. 1978), which held that it was not a breach of the fiduciary duties owed by trustees of a public retirement fund to purchase NY city bonds – even though these bonds were not financially secure – where the purchase was considered necessary to prevent the city becoming bankrupt, and adversely affecting the solvency of the retirement fund. Although turning on its own facts, this case supports the view that ESG considerations can be taken into account in assessing the likely implications and consequences of an investment.

⁴⁶¹ *Restatement (Third) of Trusts: P.I.R.* § 227, comment c. Some commentators have described this concept as the duty of obedience to the mission of a charitable trust – that is that charitable trusts are required to ensure that their organisation carries out its charitable purposes.

An even broader view is taken in the leading US trusts treatise, *Scott on Trusts*, which concludes that:⁴⁶²

'Trustees in deciding whether to invest in, or to retain, the securities of a corporation may properly consider the social performance of the corporation. They may decline to invest in, or to retain, the securities of corporations whose activities or some of them are contrary to fundamental and generally accepted ethical principles. They may consider such matters as pollution, race discrimination, fair employment, and consumer responsibility.'

Moreover, an important consideration for investment decision-makers is the duty of impartiality between different beneficiaries, especially as it applies to different classes of beneficiaries over time.⁴⁶³ There is an argument, recognised in US case law, that this duty incorporates aspects of intergenerational fairness, which requires trustees to take a long-term view of the consequences of their investment decisions. Thus, in one well-known case, a Federal District Court held that a pension fund must be managed with a view to meeting future as well as present obligations.⁴⁶⁴

Finally, it should be noted that, should any question arise as to whether a trustee has complied with its fiduciary duties, the burden of proof rests firmly on an objecting beneficiary to demonstrate a breach.⁴⁶⁵

UPIA

UPIA cements the prudent investor rule and modern portfolio theory. In § 2(c), UPIA lists a number of circumstances a trustee 'shall' consider as relevant to the trust or its beneficiaries:

Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:

- (1) general economic conditions;
- (2) the possible effect of inflation or deflation;
- (3) the expected tax consequences of investment decisions or strategies;
- (4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;
- (5) the expected total return from income and the appreciation of capital;
- (6) other resources of the beneficiaries;
- (7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and
- (8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

UPIA §2(c) gives a trustee significant flexibility in taking account of ESG considerations – particularly to the extent they may have a financial impact on the investment risk or return, but also to the extent an asset may have a 'special relationship...to the purposes of the trust or to one or more of the

⁴⁶² III *Scott on Trusts*, § 227.17 (W. Fratcher 4th ed. 1988), cited with approval in *City of Baltimore, op cit.* Edward Halbach, the Reporter for the Third Restatement, has described Professor Scott – who authored this passage himself – as 'America's leading trust law scholar': *Significant Trends in the Trust Law of the United States*, 32 *Vand. J. Transnat'l L.* 531, 545 (1999). Scott's successor, William Fratcher, was recently the subject of a tribute article by John Langbein, the Reporter of UPIA: *Tribute to William F. Fratcher, op cit.*

⁴⁶³ See *Restatement (Second) of Trusts* § 183 (1959).

⁴⁶⁴ *Withers, op cit.*: '[I]t is more than evident, therefore, that the trustees of the TRS would have violated their fiduciary obligation had they exhausted the assets of an underfunded actuarially reserved pension system on a single class of beneficiaries (retirees). Their obligation, plainly, was to manage the fund so as to enable it to meet its obligations not only to current retirees, but also to those scheduled to retire in the future...' at 1257-1258.

⁴⁶⁵ See *Estate of Nicholas*, 177 *Cal. App.* 3d 1071, 1087 (1986).

beneficiaries’. The commentary to UPIA §5 specifically addresses the issue of social-investing and states as follows:⁴⁶⁶

‘No form of so-called ‘social-investing’ is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries – for example, by accepting below-market returns – in favour of the interests of the persons supposedly benefited by pursuing the particular social cause.’

This comment is generally uncontroversial in that it prohibits ‘sacrificing’ beneficiary interests in favour of unrelated objectives. It does not prohibit trustees having regard to ESG considerations in the context of a responsible investment strategy.

Conclusions on the role of ESG considerations in US law

While there continues to be a debate about the exact parameters of the duty, there appears to be a consensus that, so long as ESG considerations are assessed within the context of a prudent investment plan, ESG considerations can (and, where they affect estimates of value, risk and return, should) form part of the investment decision-making process. Some state laws go further. For instance, Connecticut state law expressly permits the state pension fund industry (the Treasurer) to consider the social, economic, and environmental implications of its investments.⁴⁶⁷

There appears to be no bar to integrating ESG considerations into the day-to-day process of fund management. Indeed, this would seem to follow inexorably from the acceptance of modern portfolio theory and the discretion that gives trustees to fashion diverse investment strategies – provided the focus is always on the purposes or beneficiaries of the trust and not on securing unrelated objectives. Although the Department of Labor has on occasion appeared to support an investment-by-investment approach to decision-making,⁴⁶⁸ case law and the weight of commentary indicates that US courts would almost certainly apply the modern portfolio approach in evaluating challenges to investment decisions. That is, while not entirely free from doubt, it appears that the bare profit maximisation of individual investments has not survived the modern prudent investor rule.

Additional evidence suggesting that the fiduciary duties of care and loyalty are consistent with incorporating ESG issues into investment decision-making can be grouped into prescriptive and permissive government and federal court guidance, which either obliges or encourages trustees to take account of ESG considerations:

Prescriptive guidance
<ul style="list-style-type: none"> • Fiduciaries must fully inquire into the facts surrounding a shareholder resolution and treat proxies as assets: ‘the fiduciary act of managing plan assets which are shares of corporate stock ... includes the voting of proxies appurtenant to those shares of stock’.⁴⁶⁹ • Fiduciaries must consider all circumstances of the case: a fiduciary who ‘fails to vote, or casts a vote without considering the impact of the question, or votes blindly with management’ will violate the rule of prudence.⁴⁷⁰ • Fiduciaries must make inquiries: the duty of prudence includes a duty of inquiry into the relevant facts and circumstances surrounding the investment decision, including relevant ESG considerations.⁴⁷¹

⁴⁶⁶ UPIA, § 5, comment.

⁴⁶⁷ Connecticut General Statutes § 3-13d (a).

⁴⁶⁸ See 29 C.F.R. § 2509.94-1 and Calvert Letter, *op cit*.

⁴⁶⁹ Letter from US Department of Labor to Helmuth Fandl, Chairman of the Retirement Board of Avon Products, Inc. (Feb. 23, 1988) (Avon Letter) at 393; 59 Fed. Reg. 38860.

⁴⁷⁰ Ball Signals Continued Commitment to Proxy Voting Issues at Department, 17 Pens. & Ben. Rep. (BNA) 207 (Jan. 29, 1980) (statement of David George Ball, then Assistant Secretary of Labor for Pension and Welfare Benefits Administration).

⁴⁷¹ 29 C.F.R. § 2509.94-1; 29 C.F.R. 2550.404a-1(b).

Permissive guidance

- Fiduciaries may engage in shareholder activism on environmental, social, and corporate governance issues. The Department of Labor, which enforces ERISA, has stated through its regulations that: ‘activities intended to monitor or influence the management of corporations in which the plan owns stock are consistent with a fiduciary’s obligations under ERISA where the responsible fiduciary concludes that there is a reasonable expectation that such monitoring or communication with management, by the plan alone or together with other shareholders, is likely to enhance the value of the plan’s investment in the corporation, after taking into account the costs involved.’⁴⁷² The Department has further stated that it ‘believes that this standard would not be different for portfolios designed to match the performance of market indexes (sometimes referred to as ‘index funds’). In such funds, the investments are often held on a long-term basis and the prudent exercise of proxy voting rights or other forms of corporate monitoring or communication may be the only method available for attempting to enhance the value of the portfolio.’⁴⁷³
- These two statements combine to allow pension funds to engage corporations on issues that are likely to enhance the value of the company. Given the wealth of data that demonstrates a positive link between ESG issues and financial performance, it is reasonable to conclude that such engagement is likely to enhance the value of the plan.
- ERISA fiduciaries may consider ‘collateral’ benefits, such as those offered by a ‘socially-responsible’ fund, in a fiduciary’s evaluation of a particular investment opportunity.⁴⁷⁴

4 ESG CONSIDERATIONS IN PRACTICE AND FUTURE DEVELOPMENTS

In the past, mutual funds and other institutional investors have been for the most part unwilling to challenge corporations on a variety of ESG issues. More recently, however, instead of voting with management or simply selling the stock of companies they disagree with, some mutual funds and other institutional investors have begun to energetically exercise their voting rights. In some cases this assertiveness arises because it is difficult, if not impossible, for some institutional shareholders to sell their large positions in a company. This combination of large equity holdings and voting rights means that mutual funds and other institutional investors have a great deal of power over corporations. As a consequence they have the potential to play a significant role in monitoring the companies in which they invest⁴⁷⁵.

Some pension funds, most notably the California Public Employees Retirement System (CalPERS), have taken a leadership role in this area as well. For example, CalPERS currently votes shares in keeping with the Global Sullivan Principles of Corporate Social Responsibility. In addition, CalPERS has addressed global warming by helping to launch the Investor Network on Climate Risk with the state treasurer from Connecticut, leaders of the city of New York and the state of New York retirement funds, among others.

CalPERS’ new Environmental Technology Program seeks to invest \$200m in technologies such as renewable energy, fuel cells, water purification and conservation, waste recycling and processing, and reuse of materials. This is the first step in a program with the California State Teachers’ Retirement

⁴⁷² 29 C.F.R. § 2509.94-2(3).

⁴⁷³ 59 Fed. Reg. 38860, 38862.

⁴⁷⁴ Calvert Letter, *op cit*; see also 29. C.F.R. § 2509.94-1 generally.

⁴⁷⁵ Securities & Exchange Commission, Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies (Jan. 31, 2003), 17 CFR Parts 239, 249, 270, and 274 [Release Nos. 33-8188, 34-47304, IC-25922; File No. S7-36-02], RIN 3235-AI64 (www.sec.gov/rules/final/33-8188.htm); and Securities & Exchange Commission, Proxy Voting by Investment Advisors (Jan. 31, 2003), 17 CFR Part 275 [Release No. IA-2106; File No. S7-38-02], RIN 3235-AI65 (www.sec.gov/rules/final/ia-2106.htm).

System (CalSTRS), called the ‘Green Wave’ initiative, for the two pension funds to invest \$1.5bn in cutting-edge technologies and environmentally responsible companies.

In 2003, the SEC⁴⁷⁶ determined that there would be significant benefits to requiring mutual funds and investment advisers to disclose their policies and procedures for voting in corporate elections and report how they actually voted on each issue at each company. In particular, the SEC concluded that new rules would ‘benefit investors by improving transparency and enabling fund shareholders to monitor their funds’ involvement in the governance activities of portfolio companies’. Because of this significant benefit, the SEC established rules requiring mutual funds and investment advisers (1) to disclose the policies and procedures that they use to determine how to vote proxies relating to portfolio securities and (2) to make available to shareholders the specific proxy votes that they cast in shareholder meetings of issuers of portfolio securities.

Peter Kinder, President of KLD Research & Analytics, Inc.,⁴⁷⁷ has recently argued that as a result of SEC rules, fiduciaries are now required to look at publicly traded corporations in all their aspects, not just their financials, when voting proxies.⁴⁷⁸ Kinder supports this argument by showing that, according to the SEC, the new rules arise because fiduciary duties cover the voting of proxies and require advisers to monitor corporate events. He argues, however, that the term ‘corporate events’ as used by the SEC on this occasion is not limited to events such as mergers or bankruptcies, but is, in fact, much broader. Specifically, he contends that because the SEC identifies proxy voting policies and procedures on social and corporate responsibility issues as appropriate for disclosure, those issues in themselves fall within the meaning of ‘corporate events’.

It is not yet certain to what extent this argument presently reflects US securities law as applied. It is clear, however, that the argument is in keeping with the general direction of US fiduciary law as this has developed since the 1990s. The legal interpretation of fiduciary duties in the US is a dynamic process and the country’s understanding of those duties has evolved steadily over the years to reflect changes in society and financial markets. This process will undoubtedly continue as US institutional investors adapt to the changing economic and ethical issues posed by an increasingly globalised world.

⁴⁷⁶ Ibid.

⁴⁷⁷ A consulting firm that supplies social investment research, benchmarks and compliance services to investment institutions.

⁴⁷⁸ Peter Kinder, *Pensions & the Companies They Own: Fiduciary Duties in a Changing Social Environment*. Paper presented at University of Colorado at Boulder Leeds School of Business Symposium on Business & the Broader Culture: Corporate Retirement Security: Social & Ethical Issues, March 11, 2005: (www.kld.com/resources/papers/UniversityOfColorado_050311.pdf).

Appendix A: Australia

TABLE OF DUTIES

Overview of Duties Applicable to Different Decision Makers	
Trustees (including superannuation fund trustees)	<p>A number of duties affect a trustee's ability to take account of ESG considerations, including:</p> <ul style="list-style-type: none"> ● the duty to act prudently and for a proper purpose (including in relation to trust property and investments); ● the duty to act in the best interests of beneficiaries; ● the duty to exercise due skill, care and diligence; ● the duty to properly invest trust funds; and ● in the case of superannuation trustees, the duty to formulate an investment strategy taking into account the circumstances of the trust, return, risk, diversification and the ability to discharge liabilities. <p>Where investment functions are outsourced or delegated to investment managers, trustees continue to remain responsible for the administration and investments of the trust.</p>
Responsible Entities	<p>Responsible Entities of managed investment schemes (i.e. the entity responsible for managing a managed investment scheme) are subject to a number of duties affecting their consideration of ESG matters, including:</p> <ul style="list-style-type: none"> ● the duty to exercise care and diligence; ● the duty to act in the best interests of members; and ● the duty to comply with the Constitution of the scheme (which contains provisions in relation to scheme property and investments). <p>In most cases the Responsible Entity acts in a trustee position and is also subject to the general duties of a trustee (various duties outlined above).</p>
Investment managers	<p>Investment managers are in practice expected to take into account the fiduciary and other duties of their clients when they provide advice or investment management services.</p>
Other participants	<p>Insurance companies are not ordinarily subject to fiduciary duties but are subject to statutory duties. This includes the duty to take reasonable care, and use due diligence, to see that the company gives priority to the interests of policy owners in the investment, administration and management of the assets of a statutory fund.</p> <p>Where an entity is also a company, it is also subject to certain duties such as the duty to act in good faith and for a proper purpose.</p>

STATUTORY PROVISIONS

TRUSTEES	
Legislation	Relevant Sections and Wording
Corporations Act 2001 – General duties	<p>The Corporations Act contains a number of statutory duties pertaining to all companies as well as their directors and officers. These extend to all companies, including companies acting as trustees. Of particular relevance, in sections 180, 181 and 184, are the following:</p> <ul style="list-style-type: none"> ● the duty to exercise the degree of care and diligence that a reasonable person would exercise if they were in the company's position; ● the duty to discharge their duties in good faith and in the best interests of the corporation and for a proper purpose; and ● the duty to act in good faith, honestly and not improperly use their position or information.

<p>Corporations Act 2001 – environmental, social and ethical investment disclosure laws</p>	<p>The Corporations Act contains environmental, social and ethical investment disclosure laws which apply to all products with an investment component (and will therefore apply to trustees of managed funds).</p> <p>Section 1013D(1) The product disclosure statement (<i>PDS</i>) for retail products with an investment component must include disclosure about the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment.</p> <p>More detail in relation to these requirements is given in the Corporations Regulations 2001, which require the PDS to state either:</p> <ul style="list-style-type: none"> • that labour standards or environmental, social or ethical considerations have not been taken into account; or • if one or more of those considerations have been taken into account: <ul style="list-style-type: none"> ■ which of the specific considerations have been taken into account; ■ the standards and considerations that the issuer considers to be labour standards, environmental, social or ethical considerations respectively; ■ the extent to which they were taken into account in selecting, retaining or realising an investment. <p>Chapter 7 of the Corporations Act contains a range of other provisions that apply generally to PDSs, including the following:</p> <ul style="list-style-type: none"> • a range of offences for failing to comply with the requirements of Chapter 7 (including the investment disclosure provision in section 1013D(1)) - sections 1021A to 1021P; • a range of civil actions that can be taken for non-compliance with the requirements of Chapter 7, including powers of the courts to make orders for damages, and other orders to do justice between the parties, such as declaring the contract between the issuer and the client void; ordering the repayment of money or the payment of interest; or any other orders it think necessary or desirable – sections 1022A to 1022C; • a defence to criminal offences and civil actions if the defendant can prove that s/he took reasonable steps to ensure that the disclosure statement would not be defective – sections 1021E(4) and 1022B(7); • ASIC also has the power to issue a stop order if a PDS is defective - sections 1020E(9) and 1311(1). <p>Australian Securities and Investment Commission (ASIC) Guidelines</p> <p>ASIC has released binding guidelines entitled “Disclosure: Product Disclosure Statements (and other disclosure obligations)” which provide guidance for product issuers on preparing a PDS.</p> <p>The guidelines include the following requirements:</p> <ul style="list-style-type: none"> • Product issuers must provide retail clients with sufficient detail regarding the methodology for taking the relevant ESG standards or considerations into account; any weighting system used with respect to the standards and considerations; and a description of the product issuer’s retention and realisation policies. • The PDS must include a general description of whether adherence to the methodology will be monitored or reviewed, whether there is a timeframe for monitoring or reviewing investments, and an explanation of what will happen when an investment no longer matches the stated investment policy. • The PDS must set out any specific criteria or mechanisms used for measuring ESG standards or considerations, and state where a client can find out more about the approach used.
<p>Superannuation Industry (Supervision) Act 1993</p>	<p>The Superannuation Industry (Supervision) Act imposes additional requirements on trustees of superannuation funds. The following requirements are of particular relevance:</p> <p>Section 62 The trustee of a superannuation trust must ensure that the fund is maintained solely for the purpose of generating and providing monetary benefits to members upon retirement. This is known as the “sole purpose test”, and cannot be overridden by the terms of the fund’s trust deed.</p>

	<p>Section 52 The governing rules of a superannuation trust must contain (or will be deemed to contain) the following duties applicable to the trustees:</p> <ul style="list-style-type: none"> • act honestly in all matters affecting the entity; • exercise the degree of care, skill and diligence that an ordinary prudent person would exercise in dealing with the property of another for whom the person felt morally bound to provide; • act in the best interests of beneficiaries; • not to do anything that would impede the proper performance of its functions and powers; • formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the entity including, but not limited to (1) the risk involved in making, holding and realising, and the likely return from, the entity's investments having regard to its objectives and its expected cash flow requirements; (2) the duty to diversify investments; (3) the ability of the entity to discharge its existing and prospective liabilities to manage reserves responsibly; and • allow a beneficiary access to certain information.
FUND MANAGERS	
Legislation	Relevant Sections and Wording
Corporations Act 2001	<p>The Corporations Act contains a number of duties pertaining to Responsible Entities of managed investment schemes as well as their officers and employees. By way of example:</p> <p>Sections 601FC, 601FD and 601FE The duties of a Responsible Entity includes (among other things) the duty to:</p> <ul style="list-style-type: none"> • act honestly; • exercise the degree of care and diligence that a reasonable person would exercise if they were in the Responsible Entity's position; • act in the best interests of the members and, if there is a conflict between the members' interests and its own interests, give priority to the members' interests; • ensure that scheme property is valued at regular intervals appropriate to the nature of the property, clearly identified as scheme property and held separately from the property of the Responsible Entity; • comply with the scheme's constitution and compliance plan. <p>Also, see above in relation to the general duties imposed on all companies, which includes companies acting as fund managers, in sections 180, 181 and 184 of the Act; and the environmental, social and ethical investment disclosure laws.</p>
INSURANCE COMPANIES	
Legislation	Relevant Sections and Wording
Corporations Act 2001	<p>See above in relation to:</p> <ul style="list-style-type: none"> • the general duties imposed on all companies, which includes life insurance companies, in sections 180, 181 and 184 of the Act; and • the environmental, social and ethical investment disclosure laws.
Life Insurance Act 1995	<p>The Life Insurance Act sets out various requirements relating to permissible applications of statutory life insurance fund assets. By way of example:</p> <p>Section 43(2) The assets of the statutory fund must be invested in a way that is likely to "further the business of the fund".</p> <p>Section 48 Briefly, both the life company and its directors are obliged to take reasonable care, and use due diligence, to see that in the investment, administration and management of the assets of a statutory fund, the company gives priority to the interests of owners of policies referable to the fund.</p>

Appendix B: Canada

TABLE OF DUTIES

Overview of duties applicable to different decision makers	
Decision maker	Relevant section and wording
Trustees	A trustee must exercise the care, skill, diligence and judgment that a prudent investor would exercise in making investments.
Pension plan administrators	In most provinces the applicable pension legislation has imposed a statutory prudent person requirement on the administrator of the pension plan regarding the investment of the pension fund. In a minority of provinces, the pension legislation specifically addresses the duty of prudence regarding the investment of pension plan assets.
Insurance companies	Insurance companies must follow a prudent person approach to investment to avoid undue risk of loss and obtain a reasonable return.

STATUTORY PROVISIONS

Separate legislative regimes exist in each province pertaining to trustee, pension, insurance and securities legislation (in addition to federal pension and insurance legislation applicable to federally regulated companies) and, as a result, a comprehensive review of the applicable statutory provisions is outside the scope of this report. A sample overview of the Canadian legislation is illustrated in the chart below, which briefly summarises the relevant provincial legislative provisions in Alberta, Manitoba and Ontario and the applicable federal pension and insurance legislation.

FEDERAL PROVISIONS

Trustee legislation	
Legislation	Relevant section and wording
N/A	Trustee legislation in Canada falls under provincial jurisdiction.

Pension benefits legislation	
Legislation	Relevant section and wording
<i>Pension Benefits Standards Act, 1985</i> , R.S.C. 1985, c. 32 (2 nd Supp.).	<p>In the administration of the pension plan and pension fund, the administrator shall exercise the degree of care that a person of ordinary prudence would exercise in dealing with the property of another person (s. 8(4)).</p> <p>The administrator shall invest the assets of a pension fund in accordance with the regulations and in a manner that a reasonable and prudent person would apply in respect of a portfolio of investments of a pension fund (s.8(4.1)).</p> <p>Without limiting the generality of subsection (4), an administrator who in fact possesses, or by reason of profession or business ought to possess, a particular level of knowledge or skill relevant to the administration of a pension plan or pension fund shall employ that particular level of knowledge or skill in the administration of the pension plan or pension fund (s.5).</p>

	<p>An administrator is not liable for contravening subsection (4), (4.1) or (5) if the contravention occurred because the administrator relied in good faith on</p> <p>(a) financial statements of the pension plan prepared by an accountant, or a written report of the auditor or auditors of the plan, that have been represented to the administrator as fairly reflecting the financial condition of the plan; or</p> <p>(b) a report of an accountant, an actuary, a lawyer, a notary or another professional person whose profession lends credibility to the report (s. 5.1).</p>
<i>Pension Benefits Standards Regulation, 1985, S.O.R./87-19</i>	<p>Every pension fund is to be invested in accordance with Schedule III (s. 6(1)(a)).</p> <p>A written statement of investment policies and procedures is required in respect of a plan's portfolio of investments and loans (s. 7.1).</p> <p>Under Schedule III, the "Federal Investment Rules", there are four main investment rules: (a) the 10% rule prevents a pension fund from exposing more than 10% of its assets (through the acquisition of securities or the making of a loan) to the fortunes of any one company (or other entity) and its affiliates; (b) the 30% rule prevents a pension fund from owning more than 30% of a company's voting shares; (c) the real estate/resource property rule prevents a pension fund from investing more than a prescribed percentage of its assets in real estate and/or resource property generally and establishes a limitation on any one parcel of land; and (d) the related party rule prevents or limits pension fund assets from being invested in the securities of a related party and prevents or limits "transactions" from being entered into with a related party (Schedule III).</p>

Insurance legislation	
Legislation	Relevant section and wording
<i>Insurance Companies Act,</i> R.S.C.1991	<p>Sections 490 to 514 are the investment related sections of the Act and address topics such as investment standards (s. 492) and permitted investments (s. 495).</p> <p>The directors of a company shall establish and the company shall adhere to investment and lending policies, standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments and loans to avoid undue risk of loss and obtain a reasonable return (s.492).</p>

Securities legislation	
Legislation	Relevant section and wording
N/A	<p>The trading of securities, including securities issued by mutual funds, is subject to provincial and territorial legislation. Notwithstanding the potential for regulatory fragmentation that is inherent in this regulatory scheme, the Canadian securities regulators do strive to harmonize their regulatory requirements whenever they can achieve a consensus and they have generally succeeded in doing so.</p>

ALBERTA

Trustee legislation	
Legislation	Relevant section and wording
<i>Trustee Act</i> , R.S.A. 2000 c.T-8.	<p>A trustee must invest trust funds with a view to obtaining a reasonable return while avoiding undue risk, having regard to the circumstances of the trust (s.3 (2)).</p> <p>Without restricting the matters that a trustee may consider, in planning the investment of trust funds a trustee must consider the following matters, insofar as they are relevant to the circumstances of the trust (note: all statutory requirements are not listed):</p> <p>(a) the purposes and probable duration of the trust, the total value of the trust's assets and the needs and circumstances of the beneficiaries;</p> <p>(b) the duty to act impartially towards beneficiaries and between different classes of beneficiaries;</p> <p>(d) the need to maintain the real value of the capital or income of the trust;</p> <p>(f) the importance of diversifying the investments to an extent that is appropriate to the circumstances of the trust (s.3(5)).</p> <p>A trustee is not liable for a loss in connection with the investment of trust funds that arises from a decision or course of action that a trustee exercising reasonable skill and prudence and complying with section 3 could reasonably have made or adopted (s. 4(1)).</p> <p>The investment considerations for trustees are subject to a contrary intention being expressed in the instrument creating the trust (s. 2(1)).</p>

Pension benefits legislation	
Legislation	Relevant section and wording
<i>Employment Pension Plans Act</i> , R.S.A. 2000, c. E-8.	Assets of a pension plan must be invested, and the investments must be made in accordance with the regulations and in a manner that a reasonable and prudent person would apply to the plan's portfolio of investments having regard to the plan's liabilities (s. 54).
<i>Employment Pension Plans Regulation</i> , Alta. Reg. 35/2000	<p>The asset of a pension plan must be invested, and the investment made, in accordance with the Federal Investment Rules (s. 50(3)).</p> <p>A statement of investment principles and procedures (including the categories of investment, diversification, expected rate of return) must be produced (s.51).</p>

Insurance legislation	
Legislation	Relevant section and wording
<i>Insurance Act 2000</i> R.S.A. 2000, c. I-3	<p>Sections 415 to 423 set out the investment powers. Sections 424 to 432 set out portfolio limits. An insurance company must adhere to prudent investment standards in making investment decisions and in managing its total investments (s. 416 (1)).</p> <p>Prudent investment standards are those which, in the overall context of an investment portfolio, a reasonable and prudent person would apply to investments made on behalf of another person with whom there exists a fiduciary relationship to make such investments without undue risk of loss or impairment and with a reasonable expectation of fair return or appreciation (s. 416 (2)).</p>

Securities legislation	
Legislation	Relevant section and wording
<p><i>Securities Act</i>, 2000 R.S.A. 2000, c. S-4</p>	<p>The Act governs, inter alia, the operation of mutual funds.</p> <p>Section 190 of the act provides as follows:</p> <p>In addition to any other obligation imposed by law, every person or company responsible for the management of a mutual fund shall, with respect to the mutual fund,</p> <p>(a) exercise the powers and perform the duties of its office honestly, in good faith and in the best interests of the mutual fund, and</p> <p>(b) exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances. (s. 190(1))</p> <p>(2) For the purposes of subsection (1), a person or company is deemed to be responsible for the management of a mutual fund if</p> <p>(a) the person or company has a legal power or right to control the mutual fund, or</p> <p>(b) the person or company is in fact able to control the mutual fund. (s. 190(2))</p>
<p><i>National Instrument 81-102 Mutual Funds</i></p>	<p>National Instrument 81-102 (adopted in each province including Alberta, Manitoba and Ontario) imposes a number of restrictions on the type of investments that can be made by retail mutual funds and includes provisions against conflict of interests, provisions related to valuation of investments etc. The investment restrictions are intended to promote investment diversification and to minimise investment risk.</p> <p>Section 4.4(1) of the Instrument states the following:</p> <p>An agreement or declaration of trust by which a person or company acts as manager of a mutual fund shall provide that the manager is responsible for any loss that arises out of the failure of the manager, or of any person or company retained by the manager of the mutual fund, to discharge any of the manager's responsibilities to the mutual fund,</p> <p>(a) to exercise the powers and discharge the duties of its office honestly, in good faith and in the best interests of the mutual fund, and</p> <p>(b) to exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.</p> <p>Similarly, s. 6(6) provides the following in relation to custodians of mutual funds' assets:</p> <p>The custodian and each sub-custodian of a mutual fund, in carrying out their duties concerning the safekeeping of, and dealing with, the portfolio assets of the mutual fund, shall exercise</p> <p>(a) the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances; or</p> <p>(b) at least the same degree of care as they exercise with respect to their own property of a similar kind, if this is a higher degree of care than the degree of care referred to in paragraph (a).</p>

MANITOBA

Trustee legislation	
Legislation	Relevant section and wording
<p><i>Trustee Act</i>, C.C.S.M. c. T160</p>	<p>Subject to any express provision of the law or of the will or other instrument creating the trust or defining the duties and powers of the trustee (...) a trustee may invest in any kind of property, real, personal or mixed (s.68(1)).</p> <p>Subject to any express provision of the will or other instrument creating the trust, in investing money for the benefit of another person, a trustee shall exercise the judgment and care that a person of prudence, discretion and intelligence would exercise in administering the property of others (section 68(2)).</p> <p>The powers of trustees to invest conferred by this Act are in addition to the powers conferred by the instrument creating the trust (s. 72(1)).</p> <p>The provisions of the Act do not permit a trustee to do anything that the trustee is expressly forbidden to do in the instrument creating the trust (s. 72(2)(a)) or prevent a trustee from doing anything that the trustee is specifically directed to do by the instrument creating the trust (s. 72(2)(b)).</p> <p>In an action against a trustee for failing to exercise, in respect of a particular investment, the judgment and care that a person of prudence, discretion and intelligence would exercise in administering the property of others, the trustee is not liable for loss arising from that particular investment if he satisfies the court (a) that the investment was made as the result of a general policy of investing the funds making up the trust property; and (b) that the general policy was not speculative and was a policy which a person of prudence, discretion and intelligence would follow if he were administering the property of others (s. 79).</p> <p>Subject to any express provision in the instrument creating the trust, a trustee who uses a non-financial criterion to formulate an investment policy or to make an investment decision does not thereby commit a breach of trust if, in relation to the investment policy or investment decision, the trustee exercises the judgment and care that a person of prudence, discretion and intelligence would exercise in administering the property of others. (s. 79.1)</p>

Pension benefits legislation	
Legislation	Relevant section and wording
<p><i>Pension Benefits Act</i>, C.C.S.M. c. P32</p>	<p>28.1 (2) The administrator of a pension plan shall exercise the care, diligence and skill in the administration of the plan and in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person.</p> <p>(3) The administrator of a pension plan shall use in the administration of the plan and in the administration and investment of the pension fund all relevant knowledge and skill that the administrator possesses or, by reason of the administrator's profession, business or calling, ought to possess.</p> <p>(4) Subsection (3) applies with necessary modifications to a member of a board, agency or commission made responsible by an Act of the legislature for the administration of a pension plan.</p> <p>(5) An administrator of a pension plan shall not knowingly permit the administrator's interest to conflict with the administrator's duties and powers in respect of the plan and the pension fund.</p>

<p><i>Bill 10, The Pension Benefits Amendment Act,</i> 3rd Sess., 38th Leg., Manitoba, 2005</p> <p>(Bill 10, which amends the Pension Benefits Act, comes into force on a day to fixed by proclamation (date not determined as of 1st of August 2005)).</p>	<p>21(2) Subsection 28.1(2) is amended by striking out "in the administration and investment of".</p> <p>21(3) The following is added after subsection 28.1(2):</p> <p>Investing pension assets</p> <p>281.1(2.1) The administrator of a pension plan shall invest the assets of the pension fund, and manage those investments, in accordance with the regulations and in a manner that a reasonable and prudent person would apply in investing and managing a portfolio of investments of a pension fund.</p> <p>Non-financial considerations</p> <p>28.1(2.2) Unless a pension plan otherwise provides, an administrator who uses a non-financial criterion to formulate an investment policy or to make an investment decision does not thereby commit a breach of trust or contravene this Act if, in formulating the policy or making the decision, he or she has complied with subsections (2) and (2.1).</p>
<p><i>Pension Benefits Regulation, Man. Reg. 188/87/R</i></p>	<p>The funds of a pension plan may be invested and loaned only in accordance with the Federal Investment Rules (s. 16(2)).</p> <p>A written statement of investment policies and procedures is required in respect of a plan's portfolio of investments and loans (s. 16(3)).</p>

Insurance legislation	
Legislation	Relevant section and wording
<p><i>Insurance Act,</i> C.C.S.M. c. I40</p>	<p>An insurer, incorporated and licensed under the laws of the province, may invest its surplus funds and reserve in any investments in which an insurer who has obtained an order under section 53 of the Insurance Companies Act (Canada) is permitted under that Act to invest its funds (s. 76(1)).</p>

Securities legislation	
Legislation	Relevant section and wording
<p><i>Securities Act,</i> C.C.S.M. c. S50</p>	<p>The Act governs, inter alia, investment by mutual funds.</p>
<p><i>National Instrument 81-102 Mutual Funds</i></p>	<p>National Instrument 81-102 (adopted in each province including Alberta, Manitoba and Ontario) imposes a number of restrictions on the type of investments that can be made by retail mutual funds and includes provisions against conflict of interests, provisions related to valuation of investments etc. The investment restrictions are intended to promote investment diversification and to minimise investment risk.</p> <p>See Alberta section for further commentary.</p>

ONTARIO

Trustee legislation	
Legislation	Relevant section and wording
<i>Trustee Act</i> , R.S.O. 1990, c. T.23.	<p>A trustee must exercise the care, skill, diligence and judgment that a prudent investor would exercise in making investments (s.27(1)).</p> <p>Generally a trustee may invest trust property in any form of property in which a prudent investor might invest (s.27(2)). A trustee must also consider specified investment criteria (s.27(5)) and the diversification of the investment (s.27(6)).</p> <p>The parties to the trust agreement can specify that the <i>Trustee Act</i> does not apply (s.66).</p>

Pension benefits legislation	
Legislation	Relevant section and wording
<i>Pension Benefits Act</i> , R.S.O. 1990, c. P.8	<p>The administrator of a pension plan is required to exercise the care, diligence and skill in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person (s. 22(1)).</p> <p>The administrator's interests should not conflict with the administrator's duties and powers in respect of the pension fund (s. 22(4)).</p>
<i>Pension Benefits Act Regulation</i> , R.R.O. 1990, Reg. 909.	<p>The administrator of a pension plan is required to establish a statement of investment policies and procedure for the plan that meets the requirements of the federal investment regulations (s. 78(1)).</p> <p>The assets of every pension plan are required to be invested in accordance with the federal investment regulations (s. 79).</p>

Insurance legislation	
Legislation	Relevant section and wording
<i>Insurance Act</i> , R.S.O. 1990, c. I.8.	<p>Investments are addressed in sections 432 to 437 of the Act.</p> <p>Section 433 sets out insurance companies' investment powers.</p> <p>Section 435 sets out restrictions, limitation and prohibitions concerning investment powers.</p> <p>Section 436 sets out prohibited loans and investments.</p>

Securities legislation	
Legislation	Relevant section and wording
<i>Securities Act</i> , R.S.O. 1990, c. S.5	<p>The Act governs, inter alia, the operation of mutual funds.</p> <p>Every person or company responsible for the management of a mutual fund shall exercise the powers and discharge the duties of its office honestly, in good faith and in the best interests of the mutual fund, and in connection therewith shall exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances (s. 116 (1)).</p>

<i>National Instrument 81-102 Mutual Funds</i>	<p>National Instrument 81-102 (adopted in each province including Alberta, Manitoba and Ontario) imposes a number of restrictions on the type of investments that can be made by retail mutual funds and includes provisions against conflict of interests, provisions related to valuation of investments etc. The investment restrictions are intended to promote investment diversification and to minimise investment risk.</p> <p>See Alberta section for further commentary.</p>
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Appendix C: France

TABLE OF DUTIES

Overview of Duties Applicable to Different Decision Makers	
Pension fund managers (FRR only)	<ul style="list-style-type: none"> • Ensure profitability by maximising investment returns • Act prudently • Ensure diversification • Contribute to best practice • Have regard to 2020 Landmark
Insurance company managers	<ul style="list-style-type: none"> • Invest in suitable assets • Ensure diversification • Maintain a solvency margin
Mutual fund managers	<ul style="list-style-type: none"> • Act with loyalty, diligence, neutrality and impartiality in the exclusive interests of the investors and the integrity, transparency and security of the market • Invest for diversification of risk

STATUTORY PROVISIONS

PENSIONS	
Legislation	Relevant Sections and Wording
French social security Code	<p>Sets up the framework of the French pension system.</p> <p>Article L 200-2 sets out the legal framework for a general old age insurance plan.</p> <p>Articles L 621-1 and seq. refer to the specific pension system for self-employed workers.</p>
Law n° 2001-624 amended by the law n° 2003-775 relating to the FRR	<p>This legislation has been codified in the French social security Code under articles L 135-6 and seq. defining the purpose of the FRR, its resources and its organisation.</p>
Decree n° 2001-1214 relating to the FRR	<p>The Decree has been codified in the French social security Code under articles R 135-18 and seq., and states that the FRR must comply with specific decision-making requirements (namely, the duty to bear in mind the objective and timing of the use of the FRR's assets; duty to maximise investment return; prudence and adequate spread of risk) and prudential rules in connection with its investments (including investment limitations).</p>
FRR decision of 2 April 2003	<p>Determines general investment policy guidelines, including socially responsible investment aspects, applicable to the management of FRR investment by the selected Managers. Managers are encouraged to “actively contribute to promoting best practices” and to incorporate values regarding balanced economic, social and environmental development into their analysis of financial assets and corporate governance transparency.</p>
FRR proxy voting guidelines dated 10 February 2005	<p>On 10 February 2005, the FRR published a set of broad proxy voting guidelines for Managers.</p>

MUTUAL FUNDS (OPCVM)	
Legislation	Relevant Sections and Wording
French monetary and financial Code: articles L. 214-1 and seq.	<p>The Articles set out the main rules applicable to the setting up and management of French collective investment schemes (SICAVs and FCPs).</p> <p>Pursuant to article L. 214-39, FCPEs may decide to take into account ESG considerations in their investment and voting policies. Such FCPEs must state in their rules and prospectus (i) the precise criteria used to analyse ESG considerations and the methods employed to evaluate them; and (ii) whether their management company consults external specialised valuation agencies; and describe the implementation of the ESG considerations in their annual report.</p> <p>FCPEs may be categorised as solidarity funds if they comply with specific investments ratios.</p>
French monetary and financial Code (article L. 533-4) and General Regulations of the French Financial Market Authority (article 322-31 and seq.)	<p>These articles require, in particular, that the management company acts independently and in accordance with duties of loyalty, diligence, neutrality, impartiality in the exclusive interest of investors and of the integrity, transparency and security of the market, and endeavours to avoid and resolve any conflicts of interests</p>
Decree no.89-623 dated 6 September 1989	<p>Defines the OPCVM's investment rules, focusing in particular on their risk diversification obligations.</p>
General Regulations of the French Financial Market Authority	<p>Articles 411-1 and seq. specify general provisions applicable to OPCVMs and set out in the French monetary and financial Code, in particular their filing procedure, their operating rules, information supplied to the public, and marketing rules.</p>
Instruction no.2005-05 of the French Financial Market Authority	<p>Pursuant to article 19, FCPEs taking into account ESG considerations are subject to transparency and reporting requirements.</p>
Transparency Guidelines by Association Française de la Gestion Financière - AFG (French Asset Management Association, which represents investment funds and individual portfolio management)	<p>OPCVMs which decide to comply with these guidelines on voluntary bases are required to publish a list of answers to a standard set of questions supplied within the Transparency Guidelines. These questions deal, <i>inter alia</i>, with the general operation of the OPCVMs, ESG considerations, research process, evaluation and implementation, engagement approach and the voting policy.</p>
INSURANCE COMPANIES	
Legislation	Relevant Sections and Wording
French insurance Code	<p>Pursuant to article L. 322-1, insurance companies may adopt the legal form of a limited liability company or a mutual insurance company.</p> <p>Pursuant to article L. 322-26-2, except as otherwise stated in the by-laws, mutual insurance companies are managed by a board of directors. Articles R. 322-42 and seq. outline the conditions for the setting up and management of a mutual insurance company.</p> <p>Pursuant to articles L. 331-1 and seq and R.331-1 and seq., insurance companies must at all times maintain sufficient technical reserves invested in eligible assets</p>

	(listed in article R. 332-2 and complying with risk spreading obligations as contained in articles R. 332-3 and seq.) and respect the solvency margin in accordance with the provisions of articles R.334-1 and seq.
French commercial Code	Insurance companies adopting the legal form of a limited liability company are subject to the provisions of the French commercial Code with respect to their setting up, management, etc.

Appendix D: Germany

TABLE OF DUTIES

Overview of Duties Applicable to Different Decision Makers	
Pension funds managers	<p>The responsibility for investment decision-making is borne by the fund. The fund is not permitted to transfer the business risk to another legal person.</p> <p>Pension funds managers are obliged to ensure that:</p> <ul style="list-style-type: none"> • the highest possible security and profitability are guaranteed; • there is sufficient liquidity; • adequate spread of risks is guaranteed; • investments are managed professionally to guarantee compliance with prudent investment principles; • adequate systems to control risk, efficient internal investment decision-making processes, and a sound investment policy and appropriate organisational safeguards are in place; • allowed investment forms are used; and • information requirements regarding ESG issues re fulfilled
Insurance companies managers	<p>Insurance companies' managers are obliged to ensure that:</p> <ul style="list-style-type: none"> • the highest security and profitability of investment are ensured; • there is sufficient liquidity; • adequate spread of risks is guaranteed; • investments are managed professionally; • allowed investment forms are used; and • (if applicable) information requirements regarding ESG issues are fulfilled
Mutual funds managers	<p>Mutual funds managers must</p> <ul style="list-style-type: none"> • manage the funds with the care of a prudent businessperson for the collective benefit of the investors; • act in the sole interest of the investors and the integrity of the market when performing the activities of the mutual fund; • perform the activities with due expertise, care and conscientiousness in the best interests of the funds managed by it and the integrity of the market; and • endeavour to avoid and resolve conflicts of interests
Investment consultants	<p>Investment consultants are obliged to take into account the duties of their clients when they provide advice because they are subject to duties of care under contract (subject to the terms of the contract) and in the law of negligence.</p>

STATUTORY PROVISIONS

PENSION FUNDS	
Legislation	Relevant Sections and Wording
<i>Insurance Supervision Act (Versicherungsaufsichtsgesetz, VAG)</i>	<p>Section 115 (1) The [...] capital of pension funds has to be invested in a way which guarantees the highest possible security and profitability, a sufficient liquidity and an adequate spread of risks.</p> <p>Section 115 (4) The pension fund has to inform the beneficiaries in writing if and how it takes ethical, social and ecological aspects into account in its investment policies.</p>

<i>Pension Fund Investment decree-law (Pensionsfonds-KapitalanlageVO, PFKapAV)</i>	<p>Section 1 (2) In order to guarantee compliance with the general and special investment principles, investments are to be managed professionally in particular by putting in place adequate systems to control risk, efficient in-house investment principles and control mechanisms, a sound investment policy and other organisational safeguards. [...]</p> <p>Section 2 specifies the principles of investment (Section 115 Insurance Supervision Act) via a detailed list of permitted investment forms.</p>
Future Legislation	Future Relevant Sections and Wording
<i>Seventh Amendment of the Insurance Supervision Act (BR-Drs. 446/05)</i>	Section 115 (4) will be revised as follows: the pension fund must inform the beneficiaries in principle at the time of the conclusion of the contract and annually in writing if and how it takes ethical, social and environmental considerations into account in its investment policies.
INSURANCE COMPANIES	
Legislation	Relevant Sections and Wording
<i>Insurance Supervision Act (Versicherungsaufsichtsgesetz, VAG)</i>	<p>Section 54 (1) The [...] capital of insurance companies has to be invested in the way which guarantees the highest possible security and profitability, a sufficient liquidity and an adequate spread of risks.</p> <p>Section 54 (2/3) The allowed investment forms are described in general. Furthermore, the government is authorised to define and detail the permitted investment forms in a decree-law.</p> <p>Section 10a (1) The providers of life insurances with regards to company pension schemes are obliged to provide the information required in Section 115 (4) VAG (wording: see above). That means, they have to inform if and how ESG considerations are taken into account.</p>
<i>Act on the certification of retirement arrangement contracts (AltZertG)</i>	<p>Section 7 (1) The supplier informs the contractual partner in writing before the conclusion of the contract [...] if and how ESG considerations are taken into account.</p> <p>Section 7 (4) The supplier also has to inform in his annual report in writing if and how ESG considerations are taken into account.</p>
<i>Investment decree-law (Anlageverordnung, AnIV).</i>	<p>This decree-law describes, in a detailed list, the permitted investment forms for insurance companies.</p> <p>Section 6 “Management of investments and in-house control mechanisms”</p> <p>Insurance companies have to guarantee compliance with the investment principles are decreed by Section 54(1) of the Insurance Supervision Act ... by managing investments professionally, by putting in place adequate systems to control risk, efficient in-house investment principles and control mechanisms, a sound investment policy and other organizational safeguards ...</p>
MUTUAL FUNDS	
Legislation	Relevant Sections and Wording
<i>Investment Act (InvG)</i>	<p>Section 9 (1) The capital investment company must manage the funds with the care of a prudent businessman for the collective benefit of the investors. [...]</p> <p>Section 9 (2) The capital investment company is obliged, to</p> <ul style="list-style-type: none"> ● act in the sole interest of the investors and the integrity of the market when performing its activities; ● perform its activities with due expertise, care and conscientiousness in the best interests of the funds managed by it and the integrity of the

	<p>market;</p> <ul style="list-style-type: none">• endeavour to avoid and resolve conflicts of interests [...]. <p>Section 43 (1) The contractual terms and conditions which determine the legal relationship of the capital investment company and the investors must be set out in writing before the units in the mutual fund are issued.</p> <p>Section 43 (4) This Paragraph prescribes the information the contractual terms must contain. For example the contractual terms must contain:</p> <ul style="list-style-type: none">• the principles according to which assets are to be selected;• which types of assets may be acquired, and in what proportion;• the investment tools and instruments which may be used in the management of the fund.
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Appendix E: Italy

TABLE OF DUTIES

Overview of Duties Applicable to Different Decision Makers	
Fund Managers	<p>Asset management companies and SICAVs are expected to:</p> <ul style="list-style-type: none"> ● operate independently and according to the principles and general rules set forth under applicable laws; ● operate in conformity with the investment objectives set out in the prospectus of the collective investment scheme they manage; ● refrain from any conduct that might benefit one set of managed assets, including those managed in connection with the supply of the service of portfolio management on an individual basis, at the expense of another; ● acquire adequate knowledge of the financial instruments, goods and other valuables in which the assets under management may be invested; and ● operate so as to minimise the costs borne by the collective investment scheme they manage and obtain the best possible results from the services performed, on the basis of the investment objectives of the collective investment scheme.
General duty of care in the performance of an obligation	<p>Pursuant to article 1176 of the Italian Civil Code, in performing its obligations, the obliged party shall use the care of a “good father of a family”. However, as to the performance of obligations related to a professional activity, such duty of care must be evaluated with respect to the nature of the activity performed.</p> <p>The concept of “care of good father of a family” is to be assessed on a case-by-case basis, taking into consideration all relevant elements.</p> <p>In particular, portfolio managers are subject to the duty of “<i>acting diligently, correctly and transparently in the interests of customers and the integrity of the market</i>”, according to article 21 of the FLCA.</p>
Other participants	<p>As far as pension funds are concerned, managers are expected to comply with specific requirements with regard to investment limits and eligible assets; Additionally, where the management of a pension fund is entrusted to a portfolio manager, the latter must fulfil the detailed requirements set out under the laws governing the provision of portfolio management services, particularly in relation to dealings with customers. Namely, they are expected to ensure:</p> <ul style="list-style-type: none"> ● fair dealing; ● disclosure of material interests; ● avoidance of conflicts of interest; and ● “know your customer” requirements (i.e. conduct of business rules). <p>As to the management of insurance company reserves, the applicable laws do not set forth specific principles constraining the discretion of the manager but only specify the types of eligible assets. The management of reserves must, however, be carried out in compliance with sound and prudent management criteria. In particular, in selecting investments, account must be taken of the need for safe investments, profitability, liquidity and for diversification and spreading of investments. When management of reserves is entrusted to a portfolio manager, the latter must comply with the conduct of business rules applicable to the provision of portfolio management services.</p>

STATUTORY PROVISIONS

FUND MANAGERS / PORTFOLIO MANAGEMENT ON A CLIENT-BY-CLIENT BASIS	
Legislation	Relevant Sections and Wording
<p>Financial Law Consolidated Act – FLCA (Legislative Decree no. 58 of 1998)</p> <p>Consob Regulations no. 11522 of 1998</p>	<p>Article 21 of the FLCA Performance of services Article 21 General criteria [<i>governing the provision of investment services, including portfolio management</i>]</p> <p>1. In providing investment services and non-core services, authorised intermediaries must:</p> <p>a) act diligently, correctly and transparently in the interests of customers and the integrity of the market;</p> <p>b) acquire the necessary information from customers and operate in such a way that they are always adequately informed;</p> <p>c) organise themselves in such a way as to minimise the risk of conflicts of interest and, where such conflicts arise, act in such a way as to ensure transparency and the fair treatment of customers;</p> <p>d) have resources and procedures, including internal control mechanisms, likely to ensure the efficient provision of services; and</p> <p>e) conduct an independent, sound and prudent management and make appropriate arrangements for safeguarding the rights of customers in respect of the assets entrusted to them.</p> <p>2. [...]</p> <p>Article 26 of Consob regulations no. 11522 of 1998 General rules of conduct [<i>applicable to intermediaries in the provision of investment services, including portfolio management</i>] Licensed intermediaries, in the interest of investors and the integrity of the securities market, shall:</p> <p>a) operate independently and according to the principles and general rules of the Financial Law Consolidated Act;</p> <p>b) comply with the rules for the functioning of the markets in which they operate;</p> <p>c) refrain from any conduct that might benefit one investor at the expense of another;</p> <p>d) carry out orders given by investors promptly;</p> <p>e) acquire a knowledge of own and third-party financial instruments, services and products other than investment services they provide that is adequate in relation to the type of service to be performed; and</p> <p>f) operate so as to keep down the costs borne by investors and to obtain the best possible result from each investment service, taking into account the level of risk chosen by the investor.</p> <p>Article 48 of Consob regulations no. 11522 of 1998 General rules of conduct [<i>applicable to the provision of portfolio management on a pooled basis</i>]</p> <p>1. In supplying the service of asset management on a collective basis, asset management companies and SICAVs, in the interest of the participants in collective investment undertakings and the integrity of the securities market, shall:</p> <p>a) operate independently and according to the principles and general rules of the Financial Law Consolidated Law;</p> <p>b) operate in conformity with the investment objectives set out in the prospectus of the collective investment undertakings they manage;</p> <p>c) refrain from any conduct that might benefit one set of managed assets, including</p>

	<p>those managed in connection with the supply of the service of portfolio management on an individual basis, at the expense of another;</p> <p>d) acquire adequate knowledge of the financial instruments, goods and other valuables in which the assets under management may be invested; and</p> <p>f) operate so as to keep down the costs borne by the collective investment undertakings they manage and to obtain the best possible result from the service performed, taking into account the investment objectives of the collective investment undertakings.</p>
INSURANCE COMPANIES	
Legislation	Relevant Sections and Wording
<p>Legislative Decree 174 of 1995 (Life Insurance Law)</p> <p>Legislative Decree 175 of 1995 (Non-life Insurance Law)</p>	<p>Article 26 of the Life Insurance Law</p> <p>1. Technical reserves [...] shall be covered by assets belonging to the company [...]. In selecting such assets, the company shall take into account the kind of obligations undertaken and the need for safe investment, profitability and liquidity of its investments, providing for an adequate diversification and spreading of the same. [...]</p> <p>Article 27 of the Non-Life Insurance Law</p> <p>1. Technical reserves [...] shall be covered by assets belonging to the company [...]. In selecting such assets, the company shall take account of the kind of transactions carried out and of the need for safe investment, profitability and liquidity of its investments, providing for an adequate diversification and spreading of the same. [...]</p>
PENSION FUNDS	
Legislation	Relevant Sections and Wording
<p>Ministerial Decree no. 703 of 1996</p> <p><i>Criteria and limits for the investment of the assets of pension funds and conflict of interest</i></p>	<p>Art. 2 - Management Criteria</p> <p>1. Pension funds operate in such a way so as to ensure the sound and prudent management of their assets and having as their objectives:</p> <ul style="list-style-type: none"> a) diversification of investments; b) efficient portfolio management; c) risk-spreading, also with regard to counter-party risks; d) control of transaction, management and operational costs; and e) maximisation of net returns. <p>2. Pension funds verify the performance of the management activity also through the use of benchmarks, which must be objective and comparable, to be provided for in the management agreement and which are established by the Commissione di Vigilanza [i.e., the Commission exercising supervision of pension funds] in accordance with Article 6, paragraph 4-quater, of the Legislative Decree [Legislative Decree no. 124/93].</p> <p>3. Pension funds operate ensuring fairness and adequate disclosure of material information.</p> <p>4. In managing their assets, pension funds take into account the financial needs of medium and small sized businesses.</p>
<p>Decree no. 673 of 1996</p> <p><i>Criteria and modalities for the management of pension funds by the asset management companies</i></p>	<p>Art. 1 - Rules of Conduct</p> <p>Investment funds management companies [...] shall:</p> <ul style="list-style-type: none"> a) act with due skill, care and diligence in the interest of the pension fund; b) seek in advance from the fund any information relevant for the performance of the management activity; c) keep the fund duly informed about the nature of the investments and the risks connected to them; and

	<p>d) have a proper knowledge of the securities in which managed assets of the fund are invested.</p> <p>2. Management companies execute the transactions relating to the investments of the pension fund and exercise any right attaching to such investments in the interest of the Pension Fund in compliance with the rules on securities dealings under the applicable regulations, being it understood that pension funds remain entitled to exercise the voting rights attaching to the securities in which the funds' assets are invested.</p> <p>Art. 2 - Separate Accounts</p> <p>1. Management companies:</p> <p>a) arrange for accounts to be kept for the pension fund which show, in any moment, the amount and the composition of the investments of the fund, as well as the unrealised profits /losses arising out from transactions concluded but not settled;</p> <p>b) arrange for accounts of each pension fund to be kept separate from the Management company's account, from other pensions funds' accounts, or from the accounts of other assets managed in accordance with the law; and</p> <p>c) arrange for administrative procedures which ensure internal control on the activity performed and arrange for adequate records to be kept of transactions relating to each pension fund.</p> <p>[...]</p>
Future Legislation	Future Relevant Sections and Wording
<p>Law no. 243 of 23 August 2004</p> <p><i>Delegation by the Parliament to the Italian government of the function of reforming the Italian retirement system</i></p>	<p>According to these “<i>Rules on pension schemes and delegation to the government to issue legislation in the public pension system with a view to supporting complimentary pensions and regular occupation and to reorganising agencies for mandatory pensions and welfare</i>”, the new provisions governing the Italian retirement system to be adopted by the Government will require pension funds to indicate in their annual accounts and in the communications addressed to participants if, and to what extent, priority to social, ethical and/or environmental considerations is given in (i) managing the assets deriving from subscribers' contributions and (ii) exercising the shareholder rights. The implementing legislation is yet to be introduced.</p>

Appendix F: Japan

TABLE OF DUTIES

Overview of Duties Applicable to Different Decision Makers	
Administrators of Public Pension Funds	Administrators must perform their duties in good faith on behalf of the fund.
Administrators of Corporate Pension Funds	<p>Employees' Pension Fund (EPF) Administrators must perform their duties in good faith on behalf of the fund. Although there is no definitive source of law, it is generally understood that the general duties to maximise return are owed to the beneficiaries in the same way as they are owed to the employers.</p> <p>Tax Qualified Pension Plan (TQPP) Trustees of TQPP owe a duty of care and duty of loyalty. It is generally understood that they must maximise financial returns for the beneficiaries.</p> <p>Defined-Benefit Plan (DB) Administrators are obliged to perform their duties in good faith on behalf of the beneficiaries. It is generally understood that they owe the beneficiaries a duty to maximise return on their investments.</p> <p>Mutual Aid System for Retirement Allowance of Small and Medium-Sized Business (MSMB) Administrators are required to perform their duties faithfully on behalf of the organisation. It is also generally understood that they must maximise financial returns for the beneficiaries.</p> <p>Defined-Contribution Plan (DC) Trustees of DC must perform their duties in good faith on behalf of the beneficiaries. It is also generally understood that they must maximise financial returns for the beneficiaries.</p>
Insurance companies	Insurance companies owe a duty of care to the policyholders.
Trustees/Investment Managers	Trustees/Investment Managers must perform their administration of the funds in good faith and administer the trust business with the reasonable care of a hypothetical good manager.
Investment Advisors	Investment Advisors are obliged to perform their duties under the investment advisory agreement in good faith on behalf of the customers.

STATUTORY PROVISIONS

GENERAL	
Legislation	Relevant Sections and Wording
Civil Code (Law No. 89 of 1896, as amended)	Article 644 A person who owes an obligation to perform another person's business or manages another person's property under an agreement must perform his duties in accordance with the purpose of the agreement and with the reasonable care of a hypothetical good manager.
Trust Law (Law No. 62 of 1923, as amended)	<p>Article 20 A trustee must administer the trust business in accordance with the purpose of the trust and with the reasonable care of hypothetical good manager.</p> <p>Article 22 Section 1 A trustee shall neither make the trust property his own property nor acquire any right thereon, in the name of any person whomsoever, provided however, that this shall not apply in cases where the trustee converts the trust property into his own for unavoidable reasons, upon obtaining permission of the Court.</p>

Trust Business Law (Law No. 154 of 2004)	<p>Article 28 Section 1 A Trust Company shall be obliged to obey the purpose of the trust and must perform its trust business in good faith on behalf of the beneficiaries.</p> <p>Section 2 A Trust Company must administer the trust business in accordance with the purpose of the trust and with the reasonable care of hypothetical good manager.</p>
PUBLIC PENSION FUNDS	
Legislation	Relevant Sections and Wording
Government Pension Investment Fund Law (Law No. 19 of 2000, as amended)	Article 21 Section 3 Administration officers of the fund are obliged to obey the law and regulations, decisions of the Minister of Health, Labour and Welfare pursuant to the law and the investment principles established by the fund and must perform their duties with regard to the management and administration of the fund faithfully on behalf of the fund.
Employees' Pension Law (Law No. 115 of 1954, as amended)	Article 79-4 Section 1 The Minister of Health, Labour and Welfare must establish the basic principles with regard to the fund management.
CORPORATE PENSION FUNDS	
Legislation	Relevant Sections and Wording
Employees' Pension Law (Law No. 115 of 1954, as amended)	<p>Article 120-2 Administration officers of the fund are obliged to obey all laws and regulations, decisions of the Minister of Health, Labour and Welfare pursuant to any laws, the fund regulation and resolutions of representative employees' meetings and must perform their duties stipulated in clause 3 of Article 120 faithfully on behalf of the fund.</p> <p>Article 136-3 Section 5 Operation of the fund must be carried out in a prudent and effective manner in accordance with applicable governmental orders.</p>
Defined Benefit Corporate Pension Law (Law No. 50 of 2001)	<p>Article 69 Section 1 Employers are obliged to obey all laws and regulations, decisions of the Minister of Health, Labour and Welfare pursuant to any laws and the fund regulation and must perform their duties faithfully on behalf of the beneficiaries.</p> <p>Article 70 Section 1 Administration Officers of the fund shall be obliged to obey all laws and regulations, decisions of the Minister of Health, Labour and Welfare pursuant to any laws, the fund regulations and resolutions of representative employees' meeting and must perform their duties faithfully on behalf of the beneficiaries.</p> <p>Article 71 Fund management institutions (including contracted investment advisory companies) are obliged to obey all laws and regulations and the fund management agreement and must perform their duties faithfully on behalf of the beneficiaries.</p>
Mutual Aid Law for Retirement Allowance of Small and Medium-Sized Business (Law No. 160 of 1959, as amended)	Article 63 Administration officers of the fund shall be obliged to obey all laws and regulations, decisions of the Minister of Health, Labour and Welfare pursuant to any laws and the bylaws of the fund and must perform their duties with regard to the management of treasury surplus of the fund faithfully on behalf of the fund.

<p>The Defined-Contribution Pension Law (Law No. 88 of 2001)</p>	<p>Article 43 Section 1 Employers are obliged to obey all laws and regulations, decisions of the Minister of Health, Labour and Welfare pursuant to any laws and the regulations for the Corporate Plan and must perform their duties on behalf of the beneficiaries.</p> <p>Article 44 Fund management institutions are obliged to obey all laws and regulations and the fund management agreement and must perform their duties on behalf of the beneficiaries.</p>
<p>INSURANCE COMPANIES</p>	
<p>Legislation</p>	<p>Relevant Sections and Wording</p>
<p>Insurance Business Law (Law No. 105 of 1995, as amended)</p>	<p>Article 118 Section 1 Insurance companies must establish a specific account for the insurance agreements defined in the governmental order in order to segregate assets corresponding the amount of the Reserve for such agreements from other assets.</p>
<p>Implementing Regulations of the Insurance Business Law (Reg. No. 5 of Ministry of Finance dated 29 Feb. 1996)</p>	<p>Article 74 The term “insurance agreement” referred to in Section 1 Article 118 of the Law means as follows:</p> <ol style="list-style-type: none"> 1. insurance agreements under which the insurance payment is floating depending on the value of assets belonging to the Specific Account; 2. life insurance agreements under which the balance between the value of the Reserve at the time of payment of the insurance pay-out and the amount of expected insurance pay-out is mainly borne by the policyholder; or 3. [...] insurance agreements with the Pension Fund Association or National Pension Fund Association
<p>MUTUAL FUNDS</p>	
<p>Legislation</p>	<p>Relevant Sections and Wording</p>
<p>The Law concerning Investment Trust and Investment Corporations (Law No. 198 of 1951, as amended)</p>	<p>Article 14 Section 1 The Sellers of the Beneficial Interests of the Investment Trust must perform their duties, including investment decision-making, for the Investment Trust in good faith on behalf of the beneficiaries</p> <p>Section 2 The Sellers of the Beneficial Interests of the Investment Trust must perform their duties, including investment decisions, with the reasonable care of a hypothetical good manager on behalf of the beneficiaries.</p> <p>Article 49-8 Section 1 Trustees of the Investment Trust must perform their duties, including investment management of the Investment Trust, in good faith on behalf of the beneficiaries.</p> <p>Section 2 Trustees of the Investment Trust must perform their duties including investment management of the Investment Trust with the reasonable care of a hypothetical good manager on behalf of the beneficiaries.</p> <p>Article 99 Section 1 Section 3 of Article 254, Article 254-3 ... of the Commercial Code... will apply to the directors of the Investment Corporations.</p> <p>Commercial Code: Article 254 Section 3 The relationship between a Company and its directors shall be governed by the provisions relating to Agency.</p> <p>Article 254-3 Directors shall be obliged to obey all laws and regulations and the articles of incorporation as well as all resolutions adopted at a shareholders’ meeting and to perform their duties in good faith on behalf of the Company.</p>
<p>The Law for Regulating Securities Investment Advisory Business (Law No. 74 of 1986)</p>	<p>Article 30-2 Investment Advisors are obliged to obey all laws and regulations and the purpose of the Discretionary Investment Advisory Agreement and must perform their duties with regard to the Discretionary Investment Advisory Agreement on behalf of their customers.</p>

Appendix G: Spain

TABLE OF DUTIES

Overview of Duties Applicable to Different Decision Makers	
Collective investment schemes	<p>Fund managers of collective investment schemes are required to:</p> <ul style="list-style-type: none"> ● Act with the diligence of an orderly business person and loyal representative ● Invest according to liquidity and diversification ● Act for the benefit of the unitholders
Pension Funds	<p>Pension fund managers are expected to:</p> <ul style="list-style-type: none"> ● Act with the diligence of an orderly business person ● Ensure profitability ● Ensure diversification and spread of risk ● Act in the interests of beneficiaries and participants
Insurance companies	<p>Those responsible for the investment of insurance company reserves must act with the diligence of an orderly business person and loyal representative</p>

STATUTORY PROVISIONS

COLLECTIVE INVESTMENT SCHEMES	
Legislation	Relevant Sections and Wording
<p>Law 35/2003, of 4 November 2003, on collective investment schemes⁴⁷⁹</p> <p>Royal Decree 1393/1990, of 2 November 1990⁴⁸⁰</p>	<p>Article 23 of Law 35/2003 provides that collective investment schemes must invest their assets in accordance with the following principles: (a) liquidity, (b) risk diversification (i.e., the scheme is expected to limit the concentration of its counterparty's risk by diversifying its investments) and (c) a clear definition of the company's investment profile, which must be adequately reflected in the relevant documentation. In addition, investments must be made in the assets permitted by article 30 of Law 35/2003.</p> <p>Article 40.4 of Law 35/2003 provides that the functions to be performed by a SGIIC must be carried out with the diligence of an "orderly" businessman and of a loyal representative.</p> <p>Article 46.2 of Law 35/2003 provides that a SGIIC must act for the benefit of the unit-holders and shareholders whose assets they manage.</p> <p>Article 46.4 of Law 35/2003 provides that a SGIIC will be liable to the unit-holders/ shareholders for all damage caused to them as a result of a breach of SGIIC's legal obligations and the SGIIC is also obliged to require the Custodian to assume liability for its actions carried out on behalf of the unit-holders/shareholders.</p>

⁴⁷⁹ *Ley 35/2003, de 4 de noviembre de instituciones de inversion colectiva*

⁴⁸⁰ *Real Decreto 1393/1990, de 2 de noviembre, por el que se aprueba el Reglamento de la Ley 46/1984, de 26 de diciembre, reguladora de las Instituciones de Inversión Colectiva y el Real Decreto 91/2001, de 2 de febrero, por el que se modifica parcialmente el Real Decreto 1393/1990*

CUSTODIAN OF IICS	
Legislation	Relevant Sections and Wording
<p>Law 35/2003, of 4 November 2003, on collective investment schemes⁴⁸¹</p> <p>Royal Decree 1393/1990, of 2 November 1990</p>	<p>Article 62.1 of Law 35/2003 provides that the functions to be performed by a Custodian must be carried out with the diligence of an “orderly” businessman and of a loyal representative.</p> <p>Article 62.2 of Law 35/2003 provides that the Custodian will be liable to the unitholders/shareholders for all damage caused to them as a result of its legal obligations and to undertake the supervisory functions in relation to the management duties performed by the SGIIC or directors, as the case may be.</p>
INSURANCE COMPANIES	
Legislation	Relevant Sections and Wording
<p>Legislative Royal Decree 6/2004⁴⁸²</p> <p>Royal Decree 2486/1998⁴⁸³</p> <p>Legislative Royal Decree 1564/1989⁴⁸⁴</p>	<p>Article 16 of Legislative Royal Decree 6/2004 provides that a Spanish insurer is obliged to maintain sufficient reserves- literally, “technical provisions” (<i>provisiones técnicas</i> or <i>PTs</i>) to cover the aggregate of its liabilities. For such purposes, the PTs must be adequately calculated, accounted for, and invested in suitable assets.</p> <p>Article 49.1 of Royal Decree 2486/1998 provides that the amounts of the PTs must ensure the punctual fulfillment of the Insurer’s obligations and must be made in accordance with principles of congruence, profitability, safety, liquidity and diversification of investments, while bearing in mind the financial obligations assumed by the insurer.</p> <p>Article 127 to 127 quáter of Legislative Royal Decree 1564/1989 provides that members of a board of directors of a Spanish limited liability company have the following duties:⁴⁸⁵</p> <ul style="list-style-type: none"> • The duty to act with the diligence of an “orderly” businessman and of a loyal representative; • Duty of fidelity: directors must fulfill the duties imposed on them by law and by the by-laws to act in the interest of the company (as opposed to the company’s shareholders’ individual interests); and • Duty of loyalty: directors’ duty of loyalty is aimed at avoiding conflict of interests between directors and the company and also at preventing directors from carrying out unauthorized competing activities.

⁴⁸¹ Please note that a new set of Regulations developing the Law 35/2003 (and amending the Royal Decree 1393/1990) is being discussed. We have been told that it is intended that these draft Regulations should be approved by the end of October. Please note that, as far as we are aware, these Regulations do not contain any references to ESG considerations

⁴⁸² *Real Decreto Legislativo 6/2004, de 29 de octubre por el que se aprueba el texto refundido de la ley de ordenación y supervisión de los seguros privados*

⁴⁸³ *Real Decreto 2486/1998, de 29 de noviembre, por el que se aprueba el Reglamento de Ordenación y Supervisión de los Seguros Privados*

⁴⁸⁴ *Real Decreto Legislativo 1564/1989, de 22 de diciembre, por el que se aprueba el texto refundido de la ley de sociedades anónimas*

⁴⁸⁵ This section will also apply to members of the board of directors of SGIIC, investment companies and pension managers

PENSION FUNDS	
Legislation	Relevant Sections and Wording
<p>Legislative Royal Decree 1/2002, of 29 November, by which the law on pensions plans and funds is approved⁴⁸⁶</p> <p>Royal Decree 304/2004, of 20 February, by which the Regulations on pension plans and funds is approved⁴⁸⁷</p>	<p>Article 16.1 of Legislative Royal Decree 1/2002 provides that Pension funds must invest in accordance with the principle of ability to meet forecasted future liabilities, profitability, dispersion and diversification principles and, in particular, comply with the investment limitations.</p> <p>Article 69.1 of Royal Decree 304/2004 requires the asset be invested in the interests of participants and beneficiaries and, in case of conflict of interests, priority be given to the protection of the participants and beneficiaries.</p> <p>Article 70 of Royal Decree 304/2004 sets out the types of assets in which investments are permitted.</p> <p>Article 72 of Royal Decree 304/2004 provides that investment of pension funds must at any time be sufficiently diversified in a way which prevents excessive dependence of one investment, one single issuer or group of companies, or accumulation of risk in the aggregate portfolio.</p> <p>Article 29 of Royal Decree 304/2004 provides that the pension fund's Control Commission must fulfill the following functions:</p> <ul style="list-style-type: none"> • Supervise the implementation of pension fund's performance rules (which includes the pension fund's investments policy); • Appoint the expertise required in accordance with Spanish legislation on pension funds; and • Represent the pension fund (although this function may be delegated to the Pension Manager). <p>Article 22 of Legislative Royal Decree 1/2002 provides that Pension Managers and Custodians must act in the interests of the fund they administer, and therefore are liable against the promoting entity and the beneficiaries for all damage caused as a result of breach of their respective obligations. In case of a conflict of interests, priority must be given to the protection of the interests of participants and beneficiaries.</p> <p>Article 69.2 of Royal Decree 304/2004 provides that the management of the pension fund's investments must be performed by reputable individuals with adequate qualifications and professional expertise.</p>

⁴⁸⁶ *Real Decreto Legislativo 1/2002, de 29 de noviembre, por el que se aprueba el texto refundido de la ley de regulación de los planes y fondos de pensiones*

⁴⁸⁷ *Real Decreto 304/2004, de 20 de febrero, por el que se aprueba el reglamento de planes y fondos de pensiones*

OTHER SOURCES	
<p>Spanish Securities Market Act⁴⁸⁸ Royal Decree 629/1993</p>	<p>The performance of any kind of activity directly or indirectly related to the Spanish securities markets must be carried out in compliance with: (i) the conduct rules provided by the Securities Market Law and (ii) the General Code of Conduct for the Securities Markets in Spain.⁴⁸⁹ As a result these companies (including, <i>inter alia</i>, investment companies and management companies) must:</p> <ul style="list-style-type: none"> • Act with due skill, care, diligence and transparency in the interests of their customers and in order to safeguard the integrity of the market; • Try to avoid conflicts of interest between them and their customers; • Deal fairly with customers; • Request from their customers all the information necessary for the provision of services which they are contractually obliged to provide; and • Provide timely and appropriate information to their customers regarding the results and development of the services provided.

⁴⁸⁸ *Ley 24/1988, de 28 de Julio, del Mercado de Valores (modificada por las Leyes 37/1998, de 16 de noviembre, 14/2000, de 29 de diciembre, 24/2001, de 27 de diciembre, 44/2002 de 22 de noviembre y 53/2002, de 30 de diciembre, modificado por la Ley 22/2003, de 9 de Julio, Concursal, 26/2993, de 17 de Julio, 35/2003, de 4 de noviembre, 62/2003, de 30 de diciembre y por el RD-Ley 5/2005, de 11 de marzo*

⁴⁸⁹ *Royal Decree 629/1993, of 3 May 1993*

Appendix H: United Kingdom

TABLE OF DUTIES

Overview of Duties Applicable to Different Participants	
Trustees	<p>The overriding duty that affects trustees' ability to take account of ESG considerations in administering financial trusts is their fiduciary duty to act prudently and for a proper purpose. Even where they delegate day-to-day decision making to a fund manager, trustees bear an overriding duty to ensure their investments are managed appropriately in the interests of beneficiaries.</p> <p>Foreseeably, trustees might also be liable in negligence if they fail to apply a sufficient standard of care to their decision-making, but we think it is highly unlikely that a trustee who can show that it meets its fiduciary duties would be found to have breached its duty in negligence, the content of the duty in negligence being informed by the fiduciary duty.</p>
Fund Managers	<p>Fund managers either exercise the delegated discretion of a trustee pursuant to an investment management agreement (in the case of trusts) or provide investment services to a non-trustee company (in the case of insurance reserves and non-trust personal pensions).</p> <p>Where they are managing pension investments, there are specific legislative obligations on them to consider the suitability of each investment and the need to diversify. In all cases, however, they are effectively required to have regard to the fiduciary duties applicable to trustees discussed above, by virtue of their duties in negligence and under contract.</p>
Investment consultants	<p>Investment consultants are obliged to take into account the fiduciary duties of their clients when they provide advice because, like fund managers, they are subject to duties of care under contract (subject to the terms of the contract) and in negligence.</p>
Other participants	<p>Insurance companies and non-trust pension funds are not ordinarily subject to fiduciary duties because they do not perform a custodial role. They may bear fiduciary-like duties under the terms of the instruments by which they operate but this will depend on the terms of those arrangements and will be enforceable under contract law.</p>

STATUTORY PROVISIONS

Legislation	Relevant Sections and Wording
<p>Trustee Act 2000 (ch 29 23 November 2000)</p> <p>This act applies to trustees in general, but it does not apply to trustees of an occupational pension scheme.</p>	<p>Section 1 a trustee must exercise such care and skill as is reasonable in all the circumstances, taking account of any special skills or knowledge that he/she may have.</p> <p>Section 3 trustees have a general power to deal with trust property as if it were their own.</p> <p>Section 4 a trustee must, from time to time, review the investments of the trust and consider whether they should be varied. This standard investment criteria looks at the suitability to the trust of the investments chosen and whether there is a need for investment diversification.</p> <p>Section 5 before exercising any powers of investment, a trustee must (unless it is inappropriate or unnecessary) obtain proper advice with due regard to the investment criteria. Proper advice is the advice of a person the trustee reasonably believes is qualified to give it by virtue of his ability in and practical experience of financial investments.</p> <p>Section 11 trustees can authorise any person to exercise any of their functions, with certain exceptions.</p> <p>Section 36 and Schedule 1 the general duty of care in section 1 does <i>not</i> apply to the trustees of a pension scheme. However, the duty of care does apply to a trustee</p>

	<p>when appointing agents, custodians, nominees or representatives. This includes selecting a person to act in these roles; determining the terms on which that person will act and authorising that person to exercise asset management functions and to prepare a policy statement.</p>
<p>Pensions Act 1995 (ch 26 19 July 1995)</p> <p>This act applies to those involved in the administration of occupational pension schemes.</p>	<p>Section 33(1) trustees cannot exclude liability for any duty or rule of law to take care or exercise skill in the performance of any investment function.</p> <p>Section 34 trustees have the power to invest the assets of the pension scheme as if they were solely entitled to those assets. Trustees can delegate investment decisions:</p> <p>(a) to a fund manager who is authorised by the FSA (see below) or</p> <p>(b) to a fund manager who is not so authorised provided the manager does not make investment decisions that would require him to be authorised (see below).</p> <p>Irrespective of section 33(1) above, once they have appointed a fund manager, trustees can (in the trust documents) exclude or limit their liability for the acts or defaults of this fund manager. However, trustees will not be responsible for the acts or defaults of a fund manager <i>only if</i> they have taken all reasonable steps to satisfy themselves that the fund manager has the appropriate knowledge and experience for carrying out the investment duties. It remains the duty of the trustees to ensure that the fund manager is carrying out his investment duties competently and in accordance with section 36 (see below).</p> <p>Whilst trustees can exclude their liability for the acts and defaults of the fund manager, they cannot exclude their liability for monitoring and assessing the fund manager, his performance and adherence to sections 35 and 36 of the Pensions Act 1995.</p> <p>Section 35 trustees of a pension scheme must ensure that there is a written (and updated) statement of the investment principles (<i>SIP</i>) that governs decisions about investments relating to the scheme. The SIP must cover risk; diversification and suitability of investments; the kind of investments held; the balance between the different types of investments; the expected return on the chosen investments and the realisation of the investments. Neither the trust deed nor the SIP can impose any restriction on the power to invest by reference to the consent of the employer. Trustees must ensure that any appointed fund manager invests according to the SIP.</p> <p>Section 36 trustees must exercise their investment powers with due regard for the need to diversify investments (if appropriate to the scheme) and with due regard for the suitability of the investment to the scheme. Trustees must take (and consider) advice where the investment chosen warrants such advice. Trustees must ensure that any appointed fund manager invests in accordance with this section.</p> <p>Section 47(2) trustees of occupational pension schemes must appoint a fund manager in relation to “investments” within the meaning of the Financial Services Act 1986.</p>
<p>The Occupational Pension Schemes (Investment) Regulations 1996, SI 1996/3127</p>	<p>Regulation 11A trustees must state in the SIP the extent (if at all) to which their selection, retention and realisation of investments has taken account of social, environmental or ethical considerations and must also state their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to those investments.</p>
<p>Financial Services and Markets Act 2000 (ch 8 14 June 2000)</p>	<p>Schedule 2 requires any person who is advising, arranging, managing or dealing in investments to be authorised by the Financial Services Authority (<i>FSA</i>). Rather than seek authorisation themselves, trustees will delegate their ‘day-to-day’ investment duties to an authorised fund manager and thus avoid the authorisation requirement.</p> <p>Investment consultants also fall within the provisions of FSMA and are required to be authorised.</p>

	<p>The FSA Handbook contains a number of regulatory standards applicable to “authorised persons”, such as who is “fit and proper” to be authorised and detailed regulations for financial resources, records, supervision, etc.</p> <p>The principles for all businesses regulated by FSMA</p> <p>There are a number of general principles set out in the FSA handbook which regulated businesses must adhere to:</p> <p>1 Integrity A firm must conduct its business with integrity.</p> <p>2 Skill, care and diligence A firm must conduct its business with due skill, care and diligence.</p> <p>3 Management and control A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.</p> <p>4 Financial prudence A firm must maintain adequate financial resources.</p> <p>5 Market conduct A firm must observe proper standards of market conduct.</p> <p>6 Customers’ interests A firm must pay due regard to the interests of its customers and treat them fairly.</p> <p>7 Communications with clients A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.</p> <p>8 Conflicts of interest A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.</p> <p>9 Customers: relationships of trust A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.</p> <p>10 Clients’ assets A firm must arrange adequate protection for clients’ assets when it is responsible for them.</p> <p>11 Relations with regulators A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.</p>
Future Legislation	Future Relevant Sections and Wording
<p>The Pensions Act 2004 and The Occupational Pension Schemes (Investment) Regulations 2005 (the OPSIR). Note: the OPSIR are currently in draft form.</p>	<p>Section 244 of the Pensions Act 2004 will amend the SIP requirements under s35 of the Pensions Act 1995 (see above). It was due to come into force in September 2005 but is not now expected to be enacted until late October 2005 at the earliest.</p> <p>The new provisions will require trustees to conduct a review of their SIP every 3 years and also after a significant change to any investment policy is made. Trustees must also disclose the risk measurement methods and the risk management processes to be used rather than just their general policy on ‘risk’.</p> <p>Under these new provisions, trustees must exercise their powers of investment or discretion in accordance with new Occupational Pension Schemes (Investment) Regulations 2005 (the OPSIR). The OPSIR are expected to require that the trustees use their investment powers in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole, among other things.</p> <p>The OPSIR will also require that assets are predominately invested on a regulated</p>

	<p>market and assets not so invested must be kept to a prudent level. Also, the assets of the scheme must be properly diversified so as to avoid excessive reliance on any particular asset, insurer or group of undertakings. Investments in assets issued by the same issuer or an issuer in the same group must not expose the scheme to excessive risk.</p> <p>From April 2006, section 247 of the Pensions Act 2004 places an additional requirement of knowledge and understanding on pension trustees. This section will require trustees of a pension scheme to be fully conversant with the their scheme's trust deed, the SIP and any other trust documents, pensions and trust law and any other principles relating to funding and investment. A code of practice has been released for consultation and is expected to be published in Autumn 2005.</p>
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Appendix I: United States

TABLE OF DUTIES

Overview of Duties Applicable to Different Participants	
Non-charitable trustees (including public and private pension funds and mutual funds organised as trusts)	These trustees are directly subject to the modern prudent investor rule through a range of different mechanisms, primarily ERISA for private pension funds and employee benefit schemes. Generally speaking, the modern prudent investor rule redefines the standard of prudent investment to (a) include the duty of loyalty and the duty to diversify investments; and (b) determine the prudence of an investment, at the time it was made, using modern portfolio theory. Investments are not assessed individually, but only in the context of their contribution to the overall portfolio. The trustee is also obliged to diversify and monitor investments as appropriate.
Charitable trustees	<p>At common law, these trustees are also subject to the modern prudent investor rule, but its operation in respect of charitable trusts is somewhat attenuated. In many jurisdictions, the adoption of UMIFA has relaxed the application of the prudent investor rule by applying the business judgment rule to investment decisions.</p> <p>As trustees of charities that have specific missions that are intended to benefit society and/or the environment, these trustees are under a duty of obedience to their mission. As such, these trustees may be required to consider whether the investment decision would further, or at the least, not hinder, those charitable purposes.</p>
Corporate directors and other fiduciaries (including insurance companies and mutual funds organised as corporations)	<p>These fiduciaries are not generally subject to the modern prudent investor rule (unless it has been extended to them by statute). However, under both common law and statute, directors do owe duties of both loyalty and care. In any event, the decisions of company directors are usually subject to the business judgment rule.</p> <p>Insurance companies in particular are highly controlled and limited by state regulations. Most regulations are based on ensuring the integrity of the insurer's loss reserves. Therefore, most investments must be conservative so that the insurer will have an appropriate amount of liquidity.</p>

STATUTORY PROVISIONS

Legislation	Relevant Sections and Wording
Employee Retirement Income Security Act 1974; 29 USC §§ 1001 et seq. (§ 1104 is reproduced here) <i>* Federal legislation</i>	<p>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:</p> <p>A for the exclusive purpose of:</p> <p style="padding-left: 20px;">(i) providing benefits to participants and their beneficiaries; and</p> <p style="padding-left: 20px;">(ii) defraying reasonable expenses of administering the plan;</p> <p>B with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;</p> <p>C by diversifying the investments of the plan so as to minimise the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and</p> <p>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.</p>
Restatement (Third) of Trusts: Prudent Investor Rule. §227 is reproduced here <i>*The Restatement is not</i>	<p>The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust.</p> <p>(a) This standard requires the exercise of reasonable care, skill, and caution, and</p>

<p><i>legislation, but informal codification of US common law</i></p>	<p>is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.</p> <p>(b) In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.</p> <p>(c) In addition, the trustee must:</p> <ul style="list-style-type: none"> (i) conform to fundamental fiduciary duties of loyalty (§170) and impartiality (§183); (ii) act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents (§171); and (iii) incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship (§188). <p>(d) The trustee’s duties under this Section are subject to the rule of §228, dealing primarily with contrary investment provisions of a trust or statute.</p>
<p>Uniform Prudent Investor Act (1994), §§ 2, 3 and 5 are reproduced here</p> <p><i>* Uniform laws are not primary legislation, but suggested model laws for States to adopt. 43 States plus Washington D.C. have enacted legislation based on UPIA</i></p>	<p><i>Section 2. standard of care; portfolio strategy; risk and return objectives</i></p> <p>(a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.</p> <p>(b) A trustee’s investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.</p> <p>(c) Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:</p> <ul style="list-style-type: none"> (1) general economic conditions; (2) the possible effect of inflation or deflation; (3) the expected tax consequences of investment decisions or strategies; (4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property; (5) the expected total return from income and the appreciation of capital; (6) other resources of the beneficiaries; (7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and (8) an asset’s special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries. <p>(d) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.</p> <p>(e) A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act].</p>

	<p>(f) A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.</p> <p><i>Section 3. diversification</i></p> <p>A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.</p> <p><i>Section 5. loyalty</i></p> <p>A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.</p>
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Appendix J: EU

National public policies in the EU: SRI⁴⁹⁰	
Austria	Within the Austrian Sustainability Initiative the Austrian Ministry of Agriculture, Forestry, Environment and Water Management is co-ordinating a number of measures that have a direct impact on CSR issues. The Austrian Society for Environment and Technology (ÖGUT) founded a SRI platform in 2001 with the support of the Austrian Federal Ministry of Agriculture, Forestry, Environment and Water Management. The platform aims to strengthen the market for socially responsible investment in Austria. It is a network and source of information about SRI activities in Austria and Europe and is developing a medium-term strategy to support SRI supply and demand.
Belgium	The new occupational pension law (Loi Pensions Complémentaires) of 15 May 2003 requires pension fund managers to disclose in their annual reports to what extent they consider ethical, social and/or environmental criteria in their investment policies. These annual reports are public documents.
Hungary	In the framework of privatisation of public propriety, several standards relating to such areas as employment obligations, protecting the environment and labour standards have been sent to investors by the Ministry of Employment, Policy and Labour and the Ministry of Economy in close co-operation with the investment community.
Netherlands	The 1995 Green Investment Directive promotes access to finance for environmentally sound projects. This directive provides that returns from green financial intermediaries are exempted from income taxes. A green intermediary is a financial intermediary that originates loans and investments in green projects that comply with government criteria. For asset and liability risk management reasons, green intermediaries are allowed to allocate at most 30 per cent of their assets to non-green projects, and at least 70 per cent must be invested in approved green projects. Special government agencies control and monitor green projects and decide whether a project qualifies as green.
Sweden	Under the Public Pension Funds act (2000:192), national pension funds must draw up an annual business plan that describes how environmental and ethical considerations are considered in investment activities and the impact of such considerations on funds management. According to the law, funds may not own shares in companies that violate the funds' policies on environment and ethics. The finance department has the responsibility of controlling whether funds are applying the law.
Other	<p>The voluntary quality standard for SRI research (CSRR-QS 1.0) is the first quality standard conceived in the field of SRI research and analysis, drawn up by a number of independent SRI research groups (including Ethibel, Imug, Eiris, Avanzi and Sirigroup). It aims to improve quality management systems, stimulate transparency, facilitate assurance processes and form a basis for further verification procedures.</p> <p>Based in part on current best practices, the Eurosif transparency guidelines focus on the retail SRI fund sector to increase accountability primarily to consumers. The guidelines also aim to create more clarity for asset managers, research providers and other stakeholders (see www.eurosif.org).</p>

⁴⁹⁰ Source: DG Employment, Social Affairs and Equal Opportunities *Compendium on national public policies on CSR in the European Union*, http://europa.eu.int/comm/employment_social/emplweb/csr-matrix/sr_matrix_en.cfm.

Disclaimer

This report has been prepared for UNEP FI and is designed to provide an outline of the legal and regulatory matters which arise in connection with the law and practice relating to fiduciary duties as at September 2005, as far as they apply to pension funds, mutual funds and insurance company reserves in Australia, Canada, France, Germany, Italy, Japan, Spain, the UK and the US. The report does not reflect any changes in law or practice after that date.

The information and expressions of opinions which it contains are not intended to be a comprehensive study, nor to provide legal advice, and should not be treated as a substitute for specific advice concerning individual situations by either UNEP FI or any third parties.

We supplied copies of our draft of this report to contributors who were given an opportunity to make further comments. Where we have changed the contents of the report, we have made changes at our own sole discretion and in good faith in response to such comments or further recent developments to make the report more comprehensive and accurate than it would otherwise have been. Whilst every effort has been made to ensure accuracy, no responsibility can be accepted for errors or omissions however caused.

We have neither been paid for nor sought payment for work relating to producing this report.

