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Fiduciary Duty Under the Microscope: Stewardship and the Spectrum of Pension Fund Engagement

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Session Outline

- Background of the study
- Aims and Objectives
- Current academic and policy debates
- Main findings
- Implications for research and practice
- Final remarks

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A critical issue for the future growth of investor Stewardship is whether it is compatible with the fiduciary duties of pension fund trustees

This study examines how trustees interpret their fiduciary duties and how these interpretations shape pension fund approaches to stewardship and engagement

Institutional Context, Fiduciary Duty and Stewardship

- Pension funds owe fiduciary duties to their members which is currently interpreted as a greater stewardship role towards the firms in which they are invested (The Kay Review, 2012).
- Generating investment returns over longer term therefore (in theory) their investment approach ought to reflect this (Ryan and Schneider, 2002; Davis, et al, 2006; Martin, et al, 2007).

Policy Pressure to act as ‘Stewards’

- **The Stewardship Code (2010) emphasized the need for more investor engagement and stewardship**
- The Kay Reivew (2012) emphasized the need for a shift towards long-term and **fiduciary standards**, necessitating loyalty and prudence within the investment world.
- Over 1600 signatories with more than EUR 60 trillion in assets under management as of December 2016 to the United Nations sponsored

Stewardship

- **In corporate governance literature:** it is associated with assumptions of managerial behaviour that, in contrast to agency theory are rooted in psychology and sociology and entail organisational actors seeing greater long-term utility in pro-social behaviour (Davis, et al 1997; Hernandez, 2012).
- **A shift towards Investor 'Stewardship'** is a philosophy that encourages the long-term success of companies by protecting and enhancing the value of the firm to the ultimate beneficiary of an investment (The Stewardship Code, 2010).
- **Stewardship activities** include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration (The Law Commission, 2014).

Studies in relation to pension funds and corporate governance yield mixed results.

- **Stewardship like** approach where a handful of large pension funds engage with their portfolio companies on various corporate governance issues in different ways (Solomon, et. al. 2000; Hebb, 2006; Becht, et. al. 2009; Tilba and McNulty, 2013).

vs

- **agent-like/arm's length** approach to their investments (Faccio and Lasfer, 2000; Cox, et. al, 2007; Tilba and McNulty, 2013)

Motivation behind these approaches is unclear

Academic scepticism about the Applicability of the Stewardship Code

- Fragmented share ownership (Cheffins, 2010)
- Behavioural economics cast doubts on the capacity of investors to act rationally (Arsalidou, 2014)
- Investors are reticent when it comes to Stewardship (Reisberg, 2015).
- Pension funds are focused on ‘financial’ investment outcomes (Tilba and McNulty, 2013; Tilba and Wilson, 2017).

Pension Fund Governance

- Emphasis on ‘corporate’ governance at the expense of looking at other financial institutions.
- Limited research on pension fund governance focuses on the types of pension fund engagement activities as **variables**, relating them to **specific outcomes** at the expense of shedding light on the **motivations that underpin such behaviour**.
- It is crucial to have a broader awareness of trustees’ **understanding of a purpose of a pension scheme and their duties in relation to that trust.**

Pension Fund Purpose and Trustee Duties

- **The purpose** of a pension scheme is to provide retirement benefits to its members at costs acceptable to the employer.

- **Trustees' duties** in relation to the fund are to act prudently, honestly and in the best interest of the members.

- **More recently**, these duties are also being interpreted as having a greater stewardship role towards their portfolio companies.

The Trust and Fiduciary Duties

- **The Duty of Loyalty:** Acting in the *'best interest'* of beneficiaries, i.e. acting in good faith, avoiding conflicts of interest and not deriving personal profit from the exercise of fiduciary responsibilities (Fair Pensions, 2011).
- **The Duty of Care:** to act prudently and exercise 'the care, diligence and skill that a prudent person of business would exercise in managing the affairs of others' (The Law Commission, 2011).

'Care' 'should' require an element of stewardship over investments made (The Kay Review, 2012)

Fiduciary Duty is an uncertain concept

(Sandberg, 2011; 2013; Freshfields Report, 2005; the Law Commission Consultation, 2013)

- What are the **'best interests'**? What should they be? (The Law Commission, 2013)
- ***Financial*** interests ? (Sandberg, 2011).
- The focus on '**financial**' best interest suggests that such interpretations of the fiduciary duty may preclude trustees from considering long-term and non-financial factors (Richardson, 2011; Sandberg, 2011; 2013; The Law Commission, 2013).

This motivated me to investigate this furhter

Theoretically and Practically we are left with the questions:

- What is the nature of fiduciary obligation?
- How is it understood and enacted in practice?
- How far could it be stretched beyond the maximization of short-term financial returns?

Understanding and addressing the nuances of pension fund engagement is significant given the growing emphasis on investor Stewardship

Current FRC/FCA Revisions of the Stewardship Code.

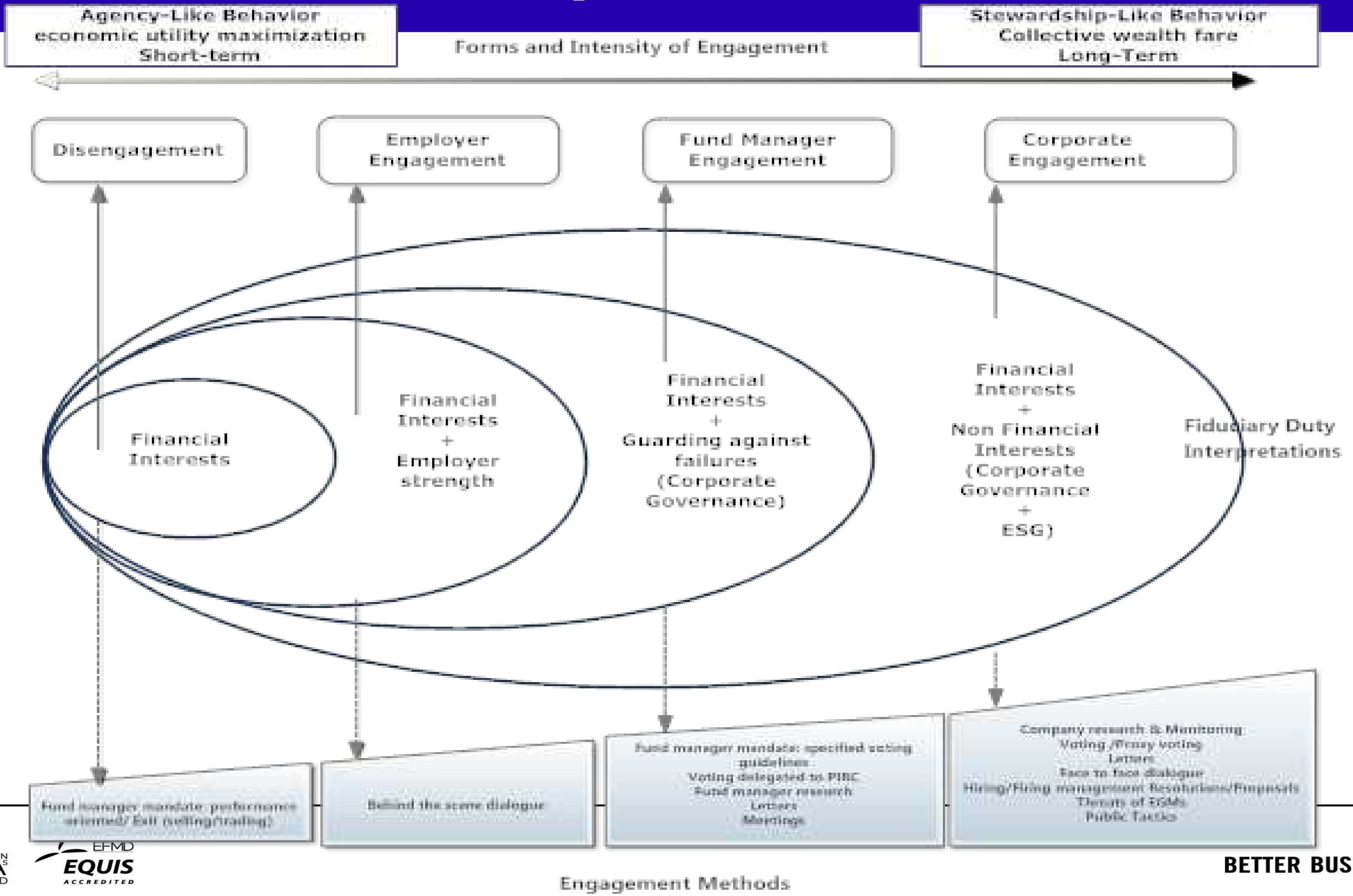
Data Sources

Interview Program:

35 Face-to-face semi-structured interviews with trustees, executives, chief investment officers, actuaries, investment consultants and fund managers.

Round Table Discussions in the context of the Law Commission Consultation on Fiduciary Duties of Investment Intermediaries (June 2013-February 2014).

Research Findings: Plurality of Interpretations



Research Findings

1. Pension funds engage with investee corporations in a variety of ways, underpinned by a distinction between either distance and agent-like behaviour or stewardship-like involvement.
2. These funds can be seen as positioned along the analytical spectrum of engagement, where some funds seek to exert more influence than others over investee companies
3. These approaches to equity ownership and stewardship are largely informed by trustees' interpretations of fiduciary duty.
4. Most funds act more like agents by focusing on maximizing investment returns because trustees broadly interpret their fiduciary duty as acting in the 'best financial interest' of beneficiaries.

Disengagement

- The predominant approach amongst UK funds.
- **Delegation**
- 'Stewardship' is largely **retrospective** and relates to investment fund managers reporting on how they voted.
- The **focus of the investment performance** within fund manager mandate
- Trustees understand their fiduciary duty primarily as the duty to act in the best ***financial*** interests of the pension fund members.

Fiduciary Duty and Disengagement

- *'We've always taken a view that we've got fiduciary duty, which is to get the appropriate level of return to meet our liabilities going forward, so we don't take account all those ESG issues, we don't screen on that basis' (Trustee)*

- *'Coming back to basics, a trustee has got to act in the members' best interest – that's just a principal trust law and that's extended in the pension's law context to say that trustees have got to act in the members best financial interest… you've got to promise that the person will get his final salary on his retirement and that there is enough money there, because you promised to pay it'. (Pensions Policy Manager)*

- *'We feel as trustees to have a duty to look after the interests of our members… and we generally try to do that by maximizing the returns relative to the risks that we take'. (Trustee)*

Fiduciary Duty and Employer Engagement

- Trustees have very little interest in how their portfolio companies are governed. **Delegated investment management**
- Significant attention is paid to **governance of their own corporate sponsor** (Engagement in the governance of the employer rather than investment portfolio companies).
- **Engagement means ensuring sustainable future for the employer**.
- Involvement with an employer means working towards a better and more financially secure future for the company. In turn, this means ensuring a strong and steady flow of pension contributions, which is beneficial for the pension fund members and the fund.

Fiduciary Duty and Employer Engagement

- *‘As a trustee one of my first and foremost duties is to ensure that there are adequate funds to pay the benefits to the members for as long as the benefits are due to be paid. In order to achieve that you have to look at the strength of the sponsor of the company. One of the huge influences on the strength of our sponsor is the fact that we’ve got this guarantee of continuing business for the next 25 years.’ (CEO)*

- *‘fundamentally we still have got the financial job to do here, that’s what the fiduciary responsibility is primarily, so you could not just give into something that you think is a really good cause – that’s charity’ (Chairman of Trustees)*

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Fiduciary Duty and Fund Manager Engagement

- Engagement **‘one level down’** at the fund manager level.
- Trustees put pressure on their fund managers (through the mandate) to engage with the investee companies on a pension fund’s behalf.
- Trustees see it as their duty not only **to maximize the investment returns, but also engage with the fund managers** in order to improve corporate governance of their investment portfolio for the financial benefits of fund members.

Fiduciary Duty and Fund Manager Engagement

- *'Trustees see that it is the job of the trustees to influence the managers around taking an interest in the companies and voting the shares… so we would have engagement at the manager level rather than at stock level' (CIO)*

- *'Motivation to engage with the managers was to recognize that pension funds were investing a great deal of money and shouldn't be complacent about what is going on in the underlying investments. Governance does go to value and you know if a company is being properly run according to good standards actually that should be in our best interests anyway because ultimately it should go to value' (Trustee)*

Fiduciary Duty and Corporate Engagement

- One underlying motivation: **engagement adds value and produces better financial returns**
- The other motivation: trustees' personal values and **sense of altruism and responsibility** that resonate with being a responsible owner of shares
- The more altruistic stance towards engagement is more evident in the local authority fund context.
- One of the reasons for such 'concentration' of responsible investment interests within the public sector funds could be the fact that the **local authorities are more pressured to have higher standards of public accountability and more is expected of these funds in terms of wider ESG issues.**

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Fiduciary Duty and Corporate Engagement

- *'Engagement adds value. It is not just altruistic...it is actually good business...there is evidence that it does add value to your shares... as much as 8% to the company value...It probably adds 20%, which is a lot' (Executive Member, LAPFF)*

- *'We are a public sector body. In our day-to-day dealings good corporate governance, transparency with the public is key in everything we do, so we are applying that rationale to the pension fund... we have real high standards of public accountability and we just believe that that should run through our investments and if we got a chance through that investment to influence – we should be doing it' (CEO).*

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Contributions

- In governance research – focusing on governance of pension funds
- Disambiguating the concept of ‘fiduciary duty’ (Sandberg, 2011; 2013): Through the Spectrum of Engagement the study demonstrates how the intensity of engagement is related to how trustees sometimes ‘stretch’ the meaning of fiduciary duty from the very minimalistic idea of acting solely in the best financial interests (focusing on generating investment returns) to considering other factors such as ESG and Stewardship.
- Developed a model linking fiduciary duty interpretations to different forms of engagement
- Providing more clarity around stewardship considerations and compatibility with current legal guidelines

- Trustees prioritise investment issues based on what they consider to be of strategic importance to the pension fund and to the interests of fund members.

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Policy Implication 1

Disconnect between policy and practice

- The implementation of fiduciary duty in practice seems removed from the notions of corporate stewardship and engagement.
- Although Stewardship can be seen as an opportunity to enhance the value of pension fund investments, it is primarily understood in a narrow way as acting in the 'best *financial* interests'.

Policy Implications 2

The Trust Deed

- There seems to be a **conflict with the regulatory framework** within which pension fund trustees operate. Namely the Trust deed.
- As a principle of general law a person acting as a trustee has to act in accordance with the **terms of the Trust** . This would normally be set out by the settlor (the creator of the trust) in the trust deed. Stewardship as a relatively new concept has not been explicitly included in the terms of the pension fund trusts.

Policy Implications 3

Delegation

- Under the duty of care and PERG 10.3, trustees delegate the day-to-day management of pension scheme investments to avoid the need for authorisation under the FSMA

(See PERG 10.3 for occupational pension schemes (OPS) https://www.handbook.fca.org.uk/handbook/PERG/10/3.html

- If trustees undertook any active monitoring of investee companies, this might bring them within the scope of regulation and potential liability which they clearly did not want to be.

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Policy Implication 4

FCA Recognition

- Effective stewardship by pension funds can presumably only be pursued if the Stewardship Code is recognised by the FCA.
- Currently the Stewardship Code isn't law, it isn't regulation, therefore it doesn't get "recognised" and therefore it is not binding.
- Under FSMA there is provision for the recognition of industry codes but as yet the FCA has not recognised any
- **Not a legal obligation but an ethical**

Final thoughts

- I highlighted some of the challenges of using fiduciary duty’ as a tool of governance.
- ‘Fiduciary Duty’ gives flexibility in dealing with uncertainty in investment management of pension fund assets.
- Such flexibility has resulted in marked differences in understanding of what the ‘best interests’ are in relation to the purpose of a pension fund.
- **Given these examples of how firms with different objectives and investment strategies approach stewardship, is there a need to re-visit the purpose of a pension fund?**