UNEP

Fiduciary responsibility

Legal and practical aspects of integrating environmental, social and governance issues into institutional investment

A report by the
Asset Management Working Group
of the United Nations Environment Programme
Finance Initiative

A follow up to the AMWG's 2005 'Freshfields Report'

July 2009

UNEP Finance Initiative
Innovative financing for sustainability

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Commonly used terms

AMWG	UNEP FI Asset Management Working Group
ESG	Environmental, social and governance (issues)
PRI	Principles for Responsible Investment
UNEP FI	United Nations Environment Programme Finance Initiative

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Foreword from the United Nations Environment Programme

UNEP

Achim Steiner
United Nations
Under-Secretary-General
and Executive Director,
United Nations
Environment Programme

Out of the ashes of the worst financial and economic crisis in generations, the 21st century global economy should invest in real and inclusive long-term growth, genuine prosperity and job creation. This is what UNEP's Green Economy Initiative and the call for a 'Global Green New Deal' is all about. Faced with the Great Depression of the 1930s, US President Franklin D. Roosevelt rapidly adopted his famous recovery-focused 'New Deal'. Today, we need similar vision, urgent action and strong political engagement to deal with the even greater and multiple challenges of our time—from climate change and extreme poverty, to biodiversity loss and ecosystem degradation, and water scarcity.

The recent crisis is part of a deep and troubling trend. It requires us to review the economic models this century has inherited from the last one. The industrial and service sector-led growth 'at any cost' may have hit its limits—limits in terms of job creation and in terms of its ecological footprint on the world's increasingly scarce nature-based assets. Gross domestic product as a measure of real wealth and as a bell-weather of economic success or failure may also have had its day in its current, narrow configuration. Climate change is perhaps the biggest market failure of all time, yet there are others in the making, many of which are linked to global warming and increasing concentrations of greenhouse gases. We are living off the Earth's capital—we need to live off the interest.

Steering the global economy onto a sustainable path and delivering a Global Green New Deal is not about sentiment, but about hard economics, real choices and a new compass for delivering genuine wealth creation. It is not about cutting growth, but about more intelligent, sustainable and inclusive growth that captures the true value of human and natural capital.

To be able to sustain their wealth creation role, investors and companies have a fundamental role to play in supporting the transition to a green economy. The recent crisis cannot be an alibi for inaction, but a call for action. As governments devise a new international financial architecture to prevent future crises of such scale, the latest report of the UNEP FI Asset Management Working Group—underpinning the integration of environmental, social and governance issues into investment policymaking and decision-making as part of a full spectrum of risks and opportunities, responsible investing, long-term thinking and sustainable solutions—offers a concrete example of the leadership and systemic change needed to realise a low carbon and resource efficient economy.

Investing in a green economy is a way of powering the world out of its current malaise of short-term thinking and an unsustainable 'brown economy.' A Global Green New Deal echoes President Roosevelt, but focuses on the even greater challenges of our time. It could also set the stage for unprecedented sustainable growth and prosperity for six billion people—without short-changing them or the planet.

UNEP is committed to continue working with the financial sector and the capital markets in making the green economy and sustainability a reality.

FINANSDEPARTEMENTET

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Foreword from the Norwegian Ministry of Finance

Kristin Halvorsen
Minister of Finance,
Norwegian Ministry
of Finance

The Norwegian Ministry of Finance is the formal owner and has overall responsibility for the management of the Government Pension Fund – Global, one of the largest funds in the world. The Fund is managed by the Ministry on behalf of the people of Norway—both present and future generations—who are the ultimate beneficiaries.

By virtue of our long-term investments in a large number of the world's companies, we have a responsibility for and an interest in promoting good corporate governance and safeguarding environmental and social concerns. In this vein, the Ministry aims towards integrating material environmental, social and governance issues, such as the risks and opportunities associated with climate change, into different parts of the management of the Fund.

Given the strength of the scientific evidence linking human activity with climate change, and the associated economic, social and political risks, I believe it is prudent for fiduciaries of financial institutions to consider the implications of climate change for strategic asset allocation decisions. The Ministry of Finance has recently detailed plans to establish a new environmental investment programme—aimed at investments that can be expected to yield indisputable environmental benefits, such as climate-friendly energy, improving energy efficiency, carbon capture and storage, water technology and management of waste and pollution. In addition, the Ministry is going to participate in a comprehensive research project managed by the consulting firm Mercer, which aims at assessing the impact of climate change on financial markets, as well as implications for strategic asset allocation. This is set up as a collaborative project where other investors are encouraged to join in.

The Ministry and Norges Bank, which undertakes the operational management of the Fund, are joint signatories to the Principles for Responsible Investment. Furthermore, the Fund is managed according to a set of Ethical Guidelines. Through the guidelines and the mechanisms under the guidelines, we signal expectations towards companies in the portfolio to respect and uphold widely shared fundamental ethical norms, such as human rights, in the conduct of their operations.

It is in this light that the Ministry welcomes this landmark publication by the United Nations Environment Programme Finance Initiative on the fiduciary responsibility of institutional investors. The report continues the debate initiated by the 2005 'Freshfields Report' of UNEP FI that explored the complex relationship between fiduciary law and environmental, social and governance issues in investment policymaking and practice.

UNEP FI's work to align investors, companies, markets and economies more closely with the goals of sustainable development is an important contribution to the advancement and dynamism of responsible investment.

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Message from the UNEP FI Asset Management Working Group

The last two years have been a tumultuous time for global investments. Asset owners and asset managers have grappled with an unprecedented financial crisis that shook many of the assumptions on which investment is grounded.

According to the International Monetary Fund's *World Economic Outlook* published in April 2009, the global economy is in a severe recession inflicted by a massive financial crisis and an acute loss of confidence, and is experiencing its deepest downturn in 50 years. In addition to its severity, this global recession qualifies as the most synchronised, as virtually all the advanced economies and many emerging and developing economies are in recession.[1] To give some context to the scale of the impact this crisis has had on the capital markets, equity investors saw the value of the MSCI World Index fall from USD 31 trillion in October 2007 to just USD 13 trillion in March 2009—a loss of USD 18 trillion or 58%—inside 18 months.[2]

Yet with times of unusual crisis often come extraordinary moments of opportunity.

For this reason, many of us in the field of responsible investment believe that the financial meltdown actually represents a unique opportunity to 'recast' some of the most basic tenets of fiduciary investment. After the fallout of the crisis, many fiduciaries will wisely look at the impact of the crisis on their investments, and look for new approaches to steward and allocate their assets.

Clearly, the origin of future systemic threats is, by nature, extremely hard to predict. However, for many years, ESG analysts have been predicting a 'Natural Resources Crisis' that is expected to originate from a widely understood combination of significant population growth, rapid economic development, depletion of non-renewable resources and physical constraints on the productive capacity of the natural environment.

The climate is without question the most important contemporary example of a range of natural resources that will cause complex and profound economic development issues if used unsustainably. In 2008, Lord Nicholas Stern reminded investors that the current financial crisis, serious as it is, pales in comparison to the dangers of runaway climate change. *The Stern Review on the Economics of Climate Change* in 2006 made it clear that climate change could represent a significant cost to the global economy. Its main conclusions were that 1% of global GDP is required to be invested a year in order to mitigate the effects of climate change, and that failure to do so could risk global GDP being up to 20% lower in 2050 than it otherwise might be.

To put this in context, the World Bank's *Global Economic Prospects 2009 – Forecast Update* published in March 2009 states that global GDP is expected to contract by 1.7% in 2009, which would be the first decline in world output on record. This marks a substantial 2.6 point deterioration from the November 2008 forecast, reflecting the rapid deterioration in financial and economic conditions—and the increasingly negative interaction between weakening economies and fragile financial systems—that have come to the fore since late 2008 for virtually every country in the world.[3]

It is therefore historic that some world leaders have voiced the urgency to combat climate change, the crucial role of finance and business, and the need for a long-term approach:

'The time for delay is over. The time for denial is over. We all believe what the scientists have been telling us for years now, that this is a matter of urgency and national security and it has to be dealt with in a serious way. That's what I intend my administration to do.'

U.S. President-elect Barack Obama, December 2008

'What we cannot afford is more short-sighted approaches. The global economy needs more than a quick fix. It needs a fundamental fix. If we have learned anything from the financial crisis, it is that we must put an end to unethical and irresponsible behaviour and the tyrannical demand for short-term profit. The price of a global bail-out may seem high, but it will pale next to the enormous human and economic costs of delaying action on climate change. Continuing to pour trillions of dollars into fossil-fuel subsidies is like investing in sub-prime real estate. Our carbon-based infrastructure is like a toxic asset that threatens the entire portfolio of global goods – from public health to food security. We must direct investment away from dirty energy industries.'

United Nations Secretary-General Ban Ki-moon, May 2009

As members of the UNEP FI Asset Management Working Group, we collectively believe that we owe our clients a duty of care that goes beyond providing robust investment products—important though this is—and extends to include identifying future challenges within the financial system, and doing what is within our power to reduce the chances of further crises.

We believe that the Natural Resources Crisis is one such potential crisis. Consequently, we are integrating ESG issues into our investment analysis and engaging with companies to promote more sustainable business practices in order to avert it.

We believe that through the integration of ESG issues into investment policymaking and decision-making, institutional investors—and the companies that they invest in—will be able to sustain their wealth creation role *and* play their fundamental role in the creation of a more sustainable global economy that invests in real and inclusive long-term growth, genuine prosperity and job creation, in line with UNEP's Green Economy Initiative[4] and the broad objectives of its 'Global Green New Deal':

- Make a major contribution to reviving the world economy, saving and creating jobs, and protecting vulnerable groups;
- Reduce carbon dependency and ecosystem degradation, putting economies on a path to clean and stable development;
- Further sustainable and inclusive growth, achieve the Millennium Development Goals, and end extreme poverty by 2015.

This context is one of our motivations to produce this 'Fiduciary II' report, a follow up to the landmark report, *A Legal Framework for the Integration of Environmental, Social and Governance Issues Into Institutional Investment*, we published four years ago—and has since been known as the 'Freshfields Report.'

Taking into account the key legal findings and recommendations within **Part I** of this report, as well as the 2005 Freshfields Report, we are collectively calling for the following actions, as we believe these will magnify the extent to which responsible investment is demanded by the capital markets:

1. Advisors to institutional investors have a duty to proactively raise ESG issues within the advice that they provide, and that a responsible investment option should be the *default* position. Therefore, responsible investment, active ownership and the promotion of sustainable business practices should be a routine part of all investment arrangements, rather than the optional add-on which many consultants appear to treat it as.

2. The Principles for Responsible Investment (PRI) should specify that—in order to maintain their membership—all asset manager and asset owner signatories will be required to embed ESG issues in their legal contracts—such as investment management agreements, and Statements of Investment Principles or Investment Policy Statements. The PRI requires that *'where consistent with fiduciary responsibilities'* signatories should commit to integrating ESG issues into investment analysis; to being active, responsible owners by promoting good corporate practice in these areas; and to reporting on what actions they have taken. We believe that embedding ESG issues in their legal contracts will help asset owners hold asset managers to account for delivering on this important aspect of asset management.

3. Similarly, all consultants, asset managers and other service providers that are signatories to the PRI should make a commitment to proactively raise ESG issues within their advisory and client take-on process.

4. Critically, the PRI monitors the performance of its signatories in delivering the six principles via a relatively detailed questionnaire. This involves an annual assessment that benchmarks each signatory's performance in relation to each principle. This analysis is then shared with signatories, many of whom unfortunately do not share it with their clients, whose assets they manage. While reporting on performance to the PRI is one principle of the PRI, signatories are not required to share these performance assessments with their clients. As asset owners have a fiduciary duty in this area, their agents should be required to make this information available to them at no additional cost. Ultimately, this will lead to more informed market demand for responsible investment.

It is true that there are systemic reasons why fiduciaries have not been demanding sufficient responsible ownership. These problems relate partly to inherent 'free rider' issues. However, **Part II** of this report has provided us with the following insights:

1. The culture within many consultants and asset managers can be to neglect these issues and to treat them with a 'tick box' mentality, rather than an issue of substance which needs to be measured and appraised. This culture should also be recognised and addressed by policymakers and civil society.

2. The most important aspect of the PRI is arguably that institutional investors, collectively representing approximately USD 18 trillion in assets under management to date, have endorsed Principle 4, which states that:

   'We will promote acceptance and implementation of the Principles within the investment industry', including possible concrete actions such as but not limited to following:

   - *'Include Principles-related requirements [ESG integration and engagement requirements] in requests for proposals (RFPs);* and
   - *'Align investment mandates, monitoring procedures, performance indicators and incentive structures accordingly (for example, ensure investment management processes reflect long-term horizons when appropriate).'*

It is our experience, however, that very few asset owner signatories to the PRI are in fact adopting this approach—and those asset owner signatories that have adopted this approach have helped generate a notable increase in the overall levels of ESG integration and engagement among asset managers. We believe that there is still some way to go on the commitment of PRI signatories to implement Principle 4, and that the key legal findings and recommendations within Part I of this report should be embedded within the PRI itself to accelerate progress.

Despite the cultural problems mentioned above, **Part III** of this report, together with our views on Parts I and II, brings us to our concluding views on fiduciaries, policymakers and civil society:

1. Fiduciaries have a duty to consider more actively the adoption of responsible investment strategies.
2. Fiduciaries must recognise that integrating ESG issues into investment and ownership processes is part of responsible investment, and is necessary to managing risk and evaluating opportunities for long-term investment.
3. Fiduciaries will increasingly come to understand the materiality of ESG issues and the systemic risk they pose, and the profound long-term costs of unsustainable development and the consequent impacts on the long-term value of their investment portfolios.
4. Fiduciaries will increasingly apply pressure to their asset managers to develop robust investment strategies that integrate ESG issues into financial analysis, and to engage with companies in order to encourage more responsible and sustainable business practices.
5. Global capital market policymakers should also make it clear that advisors to institutional investors have a duty to proactively raise ESG issues within the advice that they provide, and that a responsible investment option should be the *default* position. Furthermore, policymakers should ensure prudential regulatory frameworks that enable greater transparency and disclosure from institutional investors and their agents on the integration of ESG issues into their investment process, as well as from companies on their performance on ESG issues.
6. Finally, civil society institutions should collectively bolster their understanding of capital markets such that they can play a full role in ensuring that capital markets are sustainable and delivering responsible ownership.

The key question is whether these current trends among fiduciaries, along with commensurate actions from policymakers and civil society institutions, will reach a tipping point where the asset management industry is sufficiently engaged to help avert the Natural Resources Crisis.

Some have argued that the ongoing financial crisis may not have been so deep or so protracted if institutional investors had been collectively willing to challenge the financial institutions that were at the heart of creating the systemic risks within the financial system. We also believe that one of the most important lessons from the crisis is that institutional investors' responsible ownership needs to be strengthened in order to be fit for purpose.

In conclusion, we believe that the global economy has now reached the point where ESG issues are a critical consideration for *all* institutional investors and their agents.

In the words of United Nations Secretary-General Ban Ki-moon (May 2009):

'It is time to create market incentives that reward long-term investment…'

We believe that implementing the findings and recommendations of Fiduciary II will move us towards this goal, and help create responsible and sustainable capital markets that would accelerate the transformational process to a green, inclusive and sustainable global economy.

The UNEP FI Asset Management Working Group

Acuity Investment Management	Canada
AIG Investments	United States
Aviva Investors	United Kingdom
BNP Paribas Asset Management	France
Calvert Investments	United States
ClearBridge Advisors	United States
Eurizon Capital (Intesa Sanpaolo Group)	Italy
Groupama Asset Management	France
Henderson Global Investors	United Kingdom
HSBC Global Asset Management	France
Mitsubishi UFJ Trust & Banking Corp.	Japan
Nikko Asset Management	Japan
Pax World Management Corp.	United States
RCM	United Kingdom
Santander Brasil Asset Management	Brazil

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Aviva Investors

BNP Paribas Asset Management

Calvert Investments

ClearBridge Advisors
A Legg Mason Company

Groupama Asset Management

Henderson Global Investors

HSBC

Intesa Sanpaolo

MUFG Mitsubishi UFJ Financial Group

nikko am

PAX
Pax World Mutual Funds

RCM

Grupo Santander Brasil

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Executive summary

I. Background and context

The single most effective document for promoting the integration of environmental, social and governance (ESG) issues into institutional investment has arguably been the 'Freshfields Report'[5] published in 2005, which the UNEP FI Asset Management Working Group (AMWG) commissioned to Freshfields Bruckhaus Deringer, a leading international law firm.

Freshfields covered nine jurisdictions (i.e. Australia, Canada, France, Germany, Italy, Japan, Spain, the UK and the US) and concluded that:

'…integrating ESG considerations into an investment analysis so as to more reliably predict financial performance[6] is clearly permissible and is arguably required in all jurisdictions.'

This clear conclusion is routinely cited by practitioners, academics and opinion formers worldwide and has served to clarify the legality behind the consideration of ESG issues with respect to pension funds, insurance company reserves and mutual funds, as well as foundations.

In the four years since the launch of the original Freshfields Report by the AMWG, we have seen more innovation and evolution in the field of ESG integration than in any other similar time span in history.

Perhaps the most significant development in this time period was the launch of the Principles for Responsible Investment (PRI) in 2006 by then UN Secretary-General Kofi Annan. Now, with over 550 signatories from the institutional investment community, including many of the world's largest pension funds, collectively representing approximately USD 18 trillion in assets under management, the PRI is helping identify best practices among investors.

Clearly, much progress has been made since the publication of the Freshfields Report, but the AMWG believes even more can and must be done.

For this reason, this latest AMWG report, termed 'Fiduciary II', serves as a sequel to the Freshfields Report by providing a legal roadmap for fiduciaries looking for concrete steps to operationalise their commitment to responsible investment.[7]

II. Scope

Fiduciary II has three major elements:

- The first part is an exploration of the legal perspective on how best to operationalise the integration of ESG issues into the investment process, particularly with respect to investment mandates and investment management contracts.
- The second part is an analysis of responses to a pioneering survey questionnaire sent by the AMWG to investment management consulting firms, covering ESG issues as they relate to various aspects of the investment management process, including legal language. The questionnaire can be found in its entirety in Appendix C.
- The third part is a literature review that focuses on practical developments on the integration of ESG issues into the investment process, providing insights into the extent to which institutional investors have adopted, and can adopt, longer-term and more sustainable investment approaches. In addition, the literature review covers legal developments on fiduciary duty and ESG issues since, and including, the Freshfields Report.

III. Key findings

Part I - Legal commentary on fiduciary duty and the implementation of ESG in investment mandates

Recognised fiduciary law expert Paul Watchman, Chief Executive of Quayle Watchman Consulting and principal author of the Freshfields Report, articulates the evolving nature of fiduciary duties and ESG issues.

Among others, Quayle Watchman Consulting refers to important commentary from the House of Lords of the UK Parliament, specifically those made by Lord McKenzie during the passage of the Pensions Bill in 2008 in relation to pension fund considerations and the *duty* to have regard for ESG considerations:

*'There is no reason in law why trustees cannot consider social and moral criteria in addition to their usual criteria of financial returns, security and diversification. This applies to trustees of **all** pension funds.*[8]

*'It is an **obligation** on pension fund trustees not simply a right or option to state in their Statement of Investment Principles what the fund's guidelines are on responsible investment and to what extent social, environmental or ethical considerations are taken into account.'*[9]

Quayle Watchman Consulting then asserts that:

'It should also be noted, at the very least by way of assuaging the fears of those who foresee a need to build legal bulwarks against litigation for breach of pension fund fiduciary duties, that it is clear that investment, financial and business institutions have adopted a number of voluntary obligations which provide for ESG considerations to figure highly in investment, financial and business decision-making without legal challenge or concerns being voiced over a breach of fiduciary duties. For example, the Principles for Responsible Investment, the Equator Principles[10] *and the UN Global Compact Principles*[11] *have been adopted by over 550 investment institutions, 60 lending institutions and thousands of companies, respectively, without sparking controversy about the fiduciary limits of such institutions and companies.'*

Furthermore, Quayle Watchman Consulting brings ESG integration to the point of contract by advising that *'it is **necessary** for investment management agreements or the equivalent contract between pension funds and asset managers to use ESG language in order to clarify the expectations of the parties to the contract. In particular, it is important that it is made absolutely clear to beneficiaries, pension fund trustees and asset managers that ESG is regarded as a mainstream investment consideration.'*

To this end, legal experts at Arnold & Porter further articulate the rationale for ESG language and produced sample ESG provisions that create clear and enforceable legal rights and duties, all of which were endorsed by Quayle Watchman Consulting:

'In order for asset managers to properly integrate environmental, social and corporate governance ('ESG') factors into their investment strategy in the asset management context in the United States, appropriate provisions should be included in the offering materials and contractual documents related to a particular collective investment vehicle or managed account (each, an 'account').[12] *The goal of such ESG integration would be to **enhance and supplement** (and not replace) an asset manager's investment decision making process, rather than to avoid an evaluation of the potential merits of investing in certain companies based on their business involvement. While the latter approach may heighten portfolio risk (as the universe of potential investments is reduced based on screens or restrictions) and potentially run afoul of current applicable U.S. law, the former approach should generally be consistent with identifying the best possible investments from a risk-return framework, as required by current fiduciary law in the U.S.'*

'In general, many investment management agreements ('IMAs') contain language linking the investment objective and strategy pursuant to which an account is to be managed to the relevant offering materials thereof and tend to be drafted in broad terms, giving an asset manager wide discretion in making investment decisions on behalf of such account. Consequently, as further discussed herein, it would be ***prudent*** *to include ESG provisions in both the IMA and the offering materials (if any) of an account. ESG provisions may be incorporated into IMAs or other contractual documents of an account at inception, or subsequently added pursuant to the applicable amendment provisions.'*

Quayle Watchman Consulting goes on to clarify that institutional investment consultants and asset managers have a professional duty of care to *proactively* raise ESG considerations with their clients and cautions that failure to do so may have serious consequences:

'In tendering for investment mandates, it would be expected that the investment consultant or asset manager would raise ESG considerations as an issue to be taken into account and discussed with the client even if the pension fund had not specified ESG considerations as material to the tender. If the investment consultant or asset manager fails to do so, there is ***a very real risk that they will be sued for negligence*** *on the ground that they failed to discharge their professional duty of care to the client by failing to raise and take into account ESG considerations.*

'As professional investment advisers, investment consultants and asset managers are under a ***contract for services*** *rather than a* ***contract of service****. They are professional advisers to the client, not employees of the client; hence in exercising significant professional discretion... investment consultants and asset managers must be* ***proactive*** *rather than* ***reactive****.'*

Finally, Quayle Watchman Consulting outlines eight recommendations for pension funds to operationalise ESG integration in investment mandates, including the adoption of the Principles for Responsible Investment and requiring their asset managers to do so as well.

He also recommends periodic *ESG-inclusive* reporting by asset managers, and highlights the importance of a *longer-term assessment* of asset managers' performance, and linking such performance to *long-term incentives*:

'The pension fund should state the medium to long-term return period or periods over which the performance of the asset manager will be assessed. This should be linked to long-term incentives (e.g. bonuses and rewards) for meeting agreed performance targets. The pension fund should require the asset manager to report to it periodically (e.g. 6 to12 months) on the fund and on ESG requirement implementation. The pension fund and asset manager should agree on the form and standard of reporting most appropriate for the fund and its investments. The pension fund should require the asset manager to communicate its ESG expertise, including team qualifications and other resources, and how the asset manager ensures maintenance and development of such ESG expertise.'

Part II – Survey of investment management consulting firms on the integration of ESG into the investment process

This section brings to light the crucial role of consultants in the investment chain.

The pioneering AMWG survey captured good practices on ESG integration in various aspects of the investment management process (see Appendix C). Moreover, the responses have provided illumination on areas where the consultant industry can generally improve (condensed below), particularly in the context of legal advice:

1. An apparent problem with the lack of ESG integration in the consultant industry.

2. A discernable change in demand for ESG-inclusive services since the advent of the PRI in 2006.
3. Some confusion between ESG integration and traditional ethical investment approaches.
4. The consultant industry has not yet sufficiently developed measures to assess asset managers' competence on ESG integration and engagement.
5. A conflict with Quayle Watchman Consulting's legal advice on the professional duty of institutional investment consultants and asset managers to proactively raise ESG considerations with their clients.
6. A conflict with Quayle Watchman Consulting's legal advice on the necessity of embedding ESG language in investment management contracts, as well as in Statements of Investment Principles or Investment Policy Statements.
7. ESG-related disclosure laws are still evolving, and compliance must meet both the spirit and letter of the law. Policymakers and civil society have crucial roles to play.

Part III - Practical developments on the integration of ESG into the investment process

It is becoming increasingly clear that to be able to sustain their wealth creation role, institutional investors and companies also have an important role to play in supporting the creation of a more sustainable economy. This section of the report features recent developments and studies which give insights to the extent to which institutional investors are adopting longer-term investment strategies, and practical steps on how they can integrate ESG considerations into the investment process. In addition, a review of legal developments on fiduciary duty and ESG issues since, and including, the Freshfields Report is provided in Appendix A.

This section also highlights a growing number of voluntary initiatives that facilitate the integration of ESG issues into investment, financial or business decision-making, supporting Quayle Watchman Consulting's commentary on fiduciary duties, ESG issues and voluntary codes of practice or statements of principle:

'There are also a number of important investor and financial codes of practice or statements of principle, such as the Principles of Responsible Investment and the Equator Principles, whereby signatories undertake voluntarily to take into account environmental, social and/or governance (ESG) considerations in making investment and financial decisions. The market impact of voluntary instruments should not be underestimated; in practice, they are ubiquitous and applied widely by their signatories throughout those financial sectors where they have been adopted.'

While there is still a great deal of room for improvement, it is evident from these practical developments and studies that many leading institutional investors are adopting longer-term and more sustainable investment strategies, moving towards greater integration of ESG issues into overall investment philosophy and practice, and across asset classes.

***

Overall, the key conclusions of Fiduciary II are that in order to achieve the vision of the original Freshfields Report, where trustees integrate ESG issues into their decision-making, ESG issues should be embedded in the legal contract between asset owners and asset managers, with the implementation of this framework being governed by trustees via client reporting. Fiduciary II also makes a case for consultants having a duty to proactively raise ESG issues within their advisory process.

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Background and context

I. The original 'Freshfields Report'

The single most effective document for promoting the integration of environmental, social and governance (ESG) issues into institutional investment has arguably been the 'Freshfields Report'[13] published in 2005, which the UNEP FI Asset Management Working Group (AMWG) commissioned to Freshfields Bruckhaus Deringer, a leading international law firm.

The objective of Freshfields was to answer the following question put forward 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?'

Freshfields covered nine jurisdictions (i.e. Australia, Canada, France, Germany, Italy, Japan, Spain, the UK and the US) and concluded that:

'…integrating ESG considerations into an investment analysis so as to more reliably predict financial performance[14] is clearly permissible and is arguably required in all jurisdictions.'

This clear conclusion is routinely cited by practitioners, academics and opinion formers worldwide and has served to clarify the legality behind the consideration of ESG issues with respect to pension funds, insurance company reserves and mutual funds, as well as foundations.

II. The impact of the Freshfields Report

In the four years since the 2005 launch of the Freshfields Report by the AMWG—which was preceded by the equally robust conclusions of the 2004 AMWG report, *The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing*[15]—we have seen more innovation and evolution in the field of ESG integration than in any other similar time span in history. These ground-breaking reports created a near universally accepted platform in support of ESG integration on which many other initiatives were able to build.

The Principles for Responsible Investment

Perhaps the most significant development in this time period was the launch of the Principles for Responsible Investment (PRI) in 2006 by then UN Secretary-General Kofi Annan. The process of developing the Principles was jointly managed by UNEP FI and the UN Global Compact. In 2007, the PRI was endorsed by UN Secretary-General Ban Ki-moon.

The PRI is an investor initiative in partnership with UNEP FI and the UN Global Compact, and provides a framework through which institutional investors can publicly commit to incorporating ESG issues into mainstream investment decision-making and ownership practices. Now, with over 550 signatories collectively representing approximately USD 18 trillion in assets under management, the PRI is helping identify best practices among investors.

According to the PRI:

'The Principles are based on the premise that ESG issues can affect investment performance and that the appropriate consideration of these issues is part of delivering superior risk-adjusted

returns and is therefore firmly within the bounds of investors' fiduciary duties. The Principles clearly state they are to be applied only in ways that are consistent with those duties.'[16]

The PRI has attracted some of the world's largest pools of capital, including many of the largest pension funds, such as the Norwegian Government Pension Fund – Global, APG, the California Public Employees' Retirement System, the California State Teachers' Retirement System, the New York City Employees Retirement System, the New York State Teachers' Retirement System, the Canada Pension Plan Investment Board, the Government Employees Pension Fund of South Africa, and PREVI.[17]

ESG mandates by asset owners

Either as an extension of their PRI commitment or as independent endeavours, many asset owners have developed responsible investment approaches[18] and have awarded specific ESG-inclusive investment mandates. In February 2007, the French Public Service Additional Pension Scheme (ERAFP) awarded the largest SRI equity mandate in France, estimated to place EUR 1.2 billion from 2007 to 2011.[19] In October 2007, the Dutch pension fund, PGGM, announced a search for an emerging markets equity mandate that explicitly integrated ESG factors.[20] In September 2008, the UK Environment Agency announced it had awarded mandates to manage £185 million of global equities for its £1.5 billion Active Pension Fund in accordance with the PRI.[21]

New ESG-focused investment products

The growing interest among both institutional investors and retail investors in ESG investing, sustainability investing and green investing, has spawned a host of new investment products from well-established firms focused on sustainability, as well as firms that are just beginning to dip their toes in the water. In particular, institutional ESG mandates are driving asset managers to develop more sophisticated ESG-specific products, or to dedicate teams of analysts to provide overlay ESG analysis across all investment products. In addition to ESG overlays, a large number of thematic funds focused on areas such as climate change and water have emerged, seeking to capitalise on new solutions and opportunities, and the fallout of a secular shift in commodity prices, raw material input costs, global consumption patterns, and a changing political landscape.

Institutional investment consultants focusing on ESG

Another response to the increasing ESG mandates by institutional investors is that a few major global investment consulting firms have started to devote a part of their practice to responsible investment. Some of these firms are creating dedicated systems for reviewing and rating responsible investment strategies.[22]

ESG integration across asset classes and financial sectors

Beyond public equity, ESG issues are increasingly being integrated into asset classes such as private equity and property. In February 2009, the Private Equity Council in the US announced their 'Guidelines for Responsible Investment,' which was followed by similar developments on responsible investment in venture capital and private equity associations in the UK and Australia. On the other hand, since their founding in 2007, the UNEP FI Property Working Group has been producing research on responsible property investment practices, including the application of the PRI in property portfolios.[23]

The insurance industry appears to be headed in the same direction. Insurance and reinsurance companies—in their role as institutional investors—are becoming PRI signatories, either as asset owners or through their asset management arms. Some of them are, in fact, founding asset owner signatories.

Equally important is the UNEP FI Insurance Working Group's initiative to develop 'Principles for Sustainable Insurance,' focusing on the role of insurers as risk managers, risk underwriters and risk carriers, which is distinct from but complementary to the PRI—a framework that already addresses the institutional investor role of insurers. This is representative of a growing number of voluntary initiatives that facilitate the integration of ESG issues into investment, financial or business decision-making.[24]

Other developments

Bloomberg data

Pervasive financial data provider Bloomberg announced in September 2008 that it would begin providing company climate change data for investors on its data terminals.[25]

The CFA Institute

In July 2008, the CFA Institute, renowned home of the Chartered Financial Analyst (CFA) designation, announced the release of a new guide on ESG analysis.[26] This guide states that:

'Successful investing is dependent on one's ability to discern the factors that influence the market's valuation of a Company and then judge the accuracy of that valuation. Analysts are generally well versed in using financial metrics to understand those drivers of corporate value and lend skilled interpretation to what is often highly detailed accounting data. In recent years, however, non-financial factors—including environmental, social, and governance factors—have figured ever more prominently in the value of corporations.'

The Marathon Club and other long-term investor initiatives

Institutional investors have forged alliances to explore the implications of long-term investing and universal ownership. One such initiative is the Marathon Club, which was started in 2006 by a group of institutional investors focused on long-term thinking and harnessing the buying power for fund beneficiaries.[27]

III. The next stage: 'Fiduciary II'

Clearly, much progress has been made since the publication of the Freshfields Report in 2005, but the AMWG believes even more can and must be done.

For this reason, this latest AMWG report—termed 'Fiduciary II'—serves as a follow up to the Freshfields Report in scope and spirit, building on the original foundation to go further. The purpose of this sequel is to provide a legal roadmap for fiduciaries looking for concrete steps to operationalise their commitment to responsible investment.[28]

In this vein, Fiduciary II offers guidance on the following areas:

- Legal commentary on fiduciary duty and the implementation of ESG in investment mandates, including sample ESG language for investment management contracts to legally require asset managers to provide ESG integration services;
- Best practices being developed by investment consultants on ESG integration, including the assessment of asset managers' competence in providing ESG-inclusive investment strategies and approaches;
- Practical developments on ESG integration that provide insights into the extent to which institutional investors have adopted, and can adopt, longer-term and more sustainable investment approaches, as well as a review of legal developments on fiduciary duty and ESG issues since, and including, the Freshfields Report.

6

Scope and methodology

This report has three major investigative aspects:

Part I

The first is an exploration of the legal perspective on how to best operationalise the integration of ESG issues into the investment process, particularly with respect to investment mandates and investment management contracts.

For this part of the report, the AMWG sought the legal opinion of recognised experts in fiduciary law, namely, Paul Watchman of Quayle Watchman Consulting in the UK (formerly with Dewey & Le Boeuf and Freshfields Bruckhaus Deringer, and principal author of the Freshfields Report); and Michael Gerrard, Robert Holton and Aron Estaver of Arnold & Porter LLP in the US.

The AMWG requested Quayle Watchman Consulting and Arnold & Porter LLP to consider a range of questions on fiduciary duty and ESG issues, including the literature review section of this report, and also prepared draft ESG clauses for investment management agreements for their comment. Their respective legal commentaries were then synthesised by the AMWG.

The AMWG also received guidance from Jonas Kron, an independent legal expert in the US who contributed to the Freshfields Report and who has provided guidance to the Social Investment Forum with respect to US developments. He is concurrently with Trillium Asset Management Corp.

Part II

The second is an analysis of responses to a pioneering survey questionnaire sent by the AMWG to investment management consulting firms, covering ESG issues as they relate to various aspects of the investment management process, including legal language. The questionnaire can be found in its entirety in Appendix C. The AMWG invited top investment management consulting firms (as measured by assets under advisement), and specific investment consultancies where AMWG members had contacts.

The AMWG then worked with Eric Knight at the Oxford University Centre for the Environment in coming up with the analyses of the responses.

It is noteworthy that the framework of this pioneering survey has helped as the initial background information for a forthcoming more detailed investment consultant survey currently being conducted by the European Sustainable Investment Forum (Eurosif).

Part III

The third is a literature review that focuses on practical developments on the integration of ESG issues into the investment process, providing insights into the extent to which institutional investors have adopted, and can adopt, longer-term and more sustainable investment approaches. In addition, the literature review covers legal developments on fiduciary duty and ESG issues since, and including, the Freshfields Report (see Appendix A).

The AMWG worked with Claire Woods at the Oxford University Centre for the Environment in coming up with this review.

***

All contributors to this report worked with the AMWG *pro bono publico*.

7
Part I

Legal commentary on fiduciary duty and the implementation of ESG in investment mandates

One of the key functions of this report is to provide recommendations on how to best operationalise the integration of ESG issues into the investment process, particularly with respect to investment mandates and investment management contracts. This section of the report focuses on this legal question. The reason why it is of significant practical importance has been highlighted by the Universities Superannuation Scheme (USS), one of the UK's largest pension schemes. USS highlighted the extent to which it believed that short-termism originates from the contract or mandate between institutional investors and their agents (e.g. fund managers) as follows:

'There appears to be resistors to responsible investing which relate to deeply-rooted characteristics of the investment decision-making system including: the mandates that pension funds and their investment consultants set; the systems for measuring and rewarding performance (which focus on peer comparison and beating benchmarks rather than on fulfilling the long-term liabilities of pension funds); and the competencies of service providers (e.g. sell-side analysts). The effect of this resulting short-termism is that less attention is paid to responsible investment matters than is appropriate—these issues are too long-term in nature to affect the day-to-day behaviour of fund managers.'

While this comment applied to the UK, it could equally apply to any of the nine jurisdictions within the original Freshfields Report. Consequently, the AMWG sought the legal opinion of recognised experts in fiduciary law regarding how best to operationalise the integration of ESG issues into the investment process.

The AMWG is indebted to the following key opinion formers in this area:

- Paul Watchman, Chief Executive of Quayle Watchman Consulting based in the UK. He was formerly a Partner at the law firms, Dewey & LeBoeuf and Freshfields Bruckhaus Deringer, and is the principal author of the Freshfields Report.
- Michael Gerrard, Senior Counsel; Robert Holton, Partner; and Aron Estaver, Associate—all from the law firm, Arnold & Porter LLP ('Arnold & Porter') based in the US. Michael Gerrard is concurrently Professor of Professional Practice and Director of the Center for Climate Change Law at Columbia Law School.

The respective legal commentaries of Quayle Watchman Consulting and Arnold & Porter were provided principally in the context of the jurisdictions they are operating in (i.e. the UK for the former, the US for the latter). The AMWG believes that these commentaries provide invaluable insights and guidance that can be referred to by or extend to other jurisdictions.

The AMWG requested these legal experts to consider a range of questions on fiduciary duty and ESG issues, including the literature review section of this report. Furthermore, the AMWG prepared draft ESG clauses for investment management agreements for their comment.

The main questions pertained to the following:

A. What is the state of the art on fiduciary duty and ESG issues?

B. Is embedding ESG language in investment management contracts necessary, best practice or potentially restrictive?

C. Do institutional investment consultants and asset managers have a duty of care to proactively raise ESG considerations with their clients?

D. Legal commentary on the draft ESG clauses for investment management agreements prepared by the AMWG.

E. Practical recommendations for pension fund trustees on how to govern ESG considerations in their investment mandates, and how to ensure that investment mandates that take into account ESG considerations are being carried out by their asset managers.

In general, Quayle Watchman Consulting focused on items A, B, C and E above.

On the other hand, Arnold & Porter mainly focused on item D above in order to provide a guideline for asset managers to incorporate ESG factors in the governing documents of the accounts they manage, and for which Arnold & Porter produced sample investment objective and investment management contract provisions.

The AMWG then produced the following synthesis of their commentaries.

A. The evolutionary nature of fiduciary duties and ESG issues

Quayle Watchman Consulting provided the following commentary.

Under current United Kingdom company law legislation, the Companies Act 2006 (the '2006 Act') imposes duties on company directors to report on the environmental and social impacts of their business activities.[29]

The 2006 Act also codifies the duties of company directors from 2008, replacing previous directors' common law and statutory duties, including the fiduciary duties of company directors,[30] with a list of statutory duties which company law directors must discharge, including a duty under section 172(1) to have regard to the impact of the business of the company on the community and the environment.

In the Department of Trade and Industry (DTI) guidance on the duties of company directors[31], Margaret Hodge, Minister of State for Industry and the Regions states:

'There was a time when business success in the interests of shareholders was thought to be in conflict with society's aspirations for people who work in the company or in supply chain companies, for the long-term well-being of the community and protection of the environment. The law is now based on a new approach. Pursuing the interest of shareholders and embracing wider responsibilities are complementary purposes, not contradictory ones.'

The DTI Companies Bill guidance on the duty of directors to promote the success of the company under section 172 of the 2006 Act, which is the principal replacement duty for the common law fiduciary duties of company directors, also adds that 'success' is to be judged in terms of long-term increase in the value of the company rather than short-term gains.[32]

During the legislative passage of the Pensions Bill in 2008, the government was pressed in both Houses of Parliament to take the opportunity presented by the Pensions Bill to bring in legislation to clarify the fiduciary duties of pension fund trustees[33]; in particular, whether the fiduciary duties of pension fund trustees were prohibited by their fiduciary duties from considering social and moral criteria in their investment decision-making. While the government spokesmen were willing to state that there was no inconsistency in taking such criteria in account with the fiduciary duties of pension trustees; unfortunately, given equally difficult and important questions arise in respect of the clarity the fiduciary duties of pension fund trustees, the government declined to introduce amending legislation to clarify the position of pension fund trustees.

However, taking those statements into account together with the example of the 2006 Act on directors' duties as a precedent or model for the duties of all those who invest in the future prosperity of companies, it is arguable that the duties of pension fund trustees are similar to company directors common law statutory fiduciary duties but, if anything, because of the special relationship between trustees and beneficiaries, are more extensive and more long-term than the duties of company directors.[34]

There are also a number of important investor and financial codes of practice or statements of principle, such as the Principles of Responsible Investment and the Equator Principles, whereby signatories undertake voluntarily to take into account environmental, social and/or governance (ESG) considerations in making investment and financial decisions. The market impact of voluntary instruments should not be underestimated; in practice, they are ubiquitous and applied widely by their signatories throughout those financial sectors where they have been adopted. There is, however, with the exception of the 2006 Act and the Pensions Act 1995, no primary or secondary legislation or, in the narrow sense of legally enforceability by courts of law, codes of practice which require asset owners or asset managers to explicitly take into account ESG considerations in their investment decision-making. That is not to say that ESG considerations are not or should not be taken into account. For example, the requirements of fiduciary duties of pension fund trustees and hitherto the 2006 Act, such as duties of pension fund trustees to act fairly, prudently and consistently with the best interests of the beneficiaries, have been judge-made requirements rather than legislative requirements.

Equally noteworthy is that the Freshfields Report, before the UK government did so, concluded that there was nothing inconsistent with the fiduciary duties of pension fund trustees in taking into account ESG considerations in investing or divesting assets, and that it may be an unlawful breach of fiduciary duties for pension fund trustees, or on behalf of the trustees by the asset manager, to fail to consider ESG considerations where there is a material nexus between investment value and an ESG consideration or considerations[35] (e.g. in investing in mineral and energy companies, a failure to have regard of the impact on coal mining companies and oil and gas companies of climate change mitigation measures such as carbon emission allocation and trading schemes).[36]

Other commentators have even suggested that common law negligence claims could face pension fund trustees and asset managers who fail to take account of ESG considerations.[37]

An additional important point made by the Freshfields Report, which is sometimes overlooked, is that although their intentionally conservative interpretation of the law pointed to the weight of the rather scant legislation and case law on pension funds and fiduciary duties and favoured an approach based on *value* rather than *values*, the courts made obvious exceptions to this general approach for pension funds linked to faith, church or mission charities, such as cancer and heart foundations. These exceptions applied to what was described as 'crusader charities.' In the case of crusader charities, it was argued that the courts would permit values to outweigh value because of the ethical genes in the DNA of these crusader charities. For example, it is very unlikely that a failure to invest or a decision to divest by a charity in armaments, tobacco or alcohol companies would be held to be a breach of fiduciary duties if done by a charity regarded as a faith, church or health pension fund.

More recently, leading pension fund and fiduciary duties lawyers, such as Richardson[38], have moved beyond the business/value nexus case articulated by the Freshfields Report to an approach based on, among other things, ethics, universal ownership, ecological integrity, sustainability or the precautionary principle.

In the United Kingdom, important support for this more open textured approach (an approach not based on a business/value case driven view or the need to distinguish between crusader charities and pension funds generally) was given during the progress of the Pensions Bill in 2008 by Labour government spokesmen on pension reform:

'If we are to build a more successful, vibrant, modern economy we can no longer afford to view economic success as being in conflict with social and environmental goals. On the contrary these goals must be seen as integral to economic success and the very essence of sustainable development.'[39]

Some months later, during the passage of the Pensions Bill through its House of Lords stages, Lord McKenzie, in relation to pension fund considerations and pension funds generally, stated:

*'There is no reason in law why trustees cannot consider social and moral criteria in addition to their usual criteria of financial returns, security and diversification. This applies to trustees of **all** pension funds.'*[40]

Lord McKenzie also added that the government's view on the need for pension funds to have regard to ESG considerations was a duty rather than a right or option, and that this requirement should be clearly stated in pension funds' Statement of Investment Principles:

*'It is an **obligation** on pension fund trustees not simply a right or option to state in their Statement of Investment Principles what the fund's guidelines are on responsible investment and to what extent social, environmental or ethical considerations are taken into account.'*[41]

It should also be noted, at the very least by way of assuaging the fears of those who foresee a need to build legal bulwarks against litigation for breach of pension fund fiduciary duties, that it is clear that investment, financial and business institutions have adopted a number of voluntary obligations which provide for ESG considerations to figure highly in investment, financial and business decision-making without legal challenge or concerns being voiced over a breach of fiduciary duties. For example, the Principles for Responsible Investment, the Equator Principles[42] and the UN Global Compact Principles[43] have been adopted by over 550 investment institutions, 60 lending institutions and thousands of companies, respectively, without sparking controversy about the fiduciary limits of such institutions and companies.

B. Embedding ESG language in investment management contracts – Necessary, best practice or potentially restrictive?

Quayle Watchman Consulting provided the following commentary. Relevant commentary from Arnold & Porter, in the context of current US law, is stated below.

The findings of the Freshfields Report stated that ESG considerations are clearly permissible and arguably required to be taken into account in pension fund investment decisions. Since the publication of that report, government legislation and policy statements have been released which indicate that ESG considerations are relevant and material investment considerations for pension funds to take into account to the extent that they are relevant and material to investment considerations.

In light of this, it is *necessary* for investment management agreements or the equivalent contract between pension funds and asset managers to use ESG language in order to clarify the expectations of the parties to the contract. In particular, it is important that it is made absolutely clear to beneficiaries, pension fund trustees and asset managers that ESG is regarded as a mainstream investment consideration.

Approaches to embedding ESG language

There appears to be four possible approaches, each approach building on the other:

First, an asset manager may be required to monitor and assess the impact of ESG considerations generally. However, this approach, which is not uncommon in the pension fund and asset management industry, can be unlawful if it merely pays lip service to the incorporation of ESG as mainstream investment considerations. If ESG considerations are relevant and material investment considerations, they must be taken into account even if it is for the asset manger to use expertise to determine what weight to give to each investment consideration in the light of prevailing market conditions and the mandate given to the asset manager by the pension fund trustees. To attempt to rely on such an approach to cover bases without any real attempt to take ESG considerations into account or a commitment to do so merely leaves the pension fund and the asset manager exposed not only to allegations of hypocrisy, but exposure to breach of fiduciary duties which require an exceptionally high degree of honesty between the pension fund trustees and their asset managers on the one hand, and pension fund trustees and their beneficiaries on the other hand.

Discussion of ESG considerations and their application in practice should be included in the investment management contract as part of the periodic portfolio review to be held between pension fund trustees and the asset manager.

Second, as suggested above and recommended by Quayle Watchman Consulting, in addition to the first approach, at the very least and as a legal minimum to comply with their fiduciary duties, pension fund trustees should adopt and require their asset managers to adopt the Principles for Responsible Investment (PRI) and, additionally, for their asset managers to demonstrate active participation in the development of the PRI.

Third, in addition to the second approach, a pension fund in its Statement of Investment Principles or Investment Policy Statement and in the investment management contract may amplify its requirements for monitoring and assessment of ESG considerations. This may be achieved by using examples of a few international law treaties or conventions and/or voluntary guidelines or principles which the investment industry accepts widely as relevant and having a material effect on investment value. The pension fund might indicate that it expects its asset manager to have regard to compliance.

Whether this approach is too complex for the asset manager or which, if any, treaties or conventions and/or voluntary guidelines or principles should be specified will be matters of judgement by and negotiation with the pension fund trustees and their asset manager. However, specific international law treaties or conventions or voluntary guidelines or principles, which may be considered include the Universal Declaration of Human Rights, ILO conventions, World Bank or IMF guidance and policies, the Equator Principles, the Carbon Principles, the Private Equity Council Guidelines for Responsible Investment, the UN Global Compact Principles, and industry or agricultural standards, for example, in relation to coffee, cocoa, palm oil or sustainable forestry.

This approach recommends itself as there is shared experience in relation to environmental impact assessment but there is no investment industry consensus as yet in what constitutes the 'S' in ESG, or without specific reference to such instruments mentioned above, the weight the pension fund expects to be given to non-compliance with such instruments and what is expected of the asset manager.

The fourth approach combines the second and third approaches above. For example, the pension fund may specify *core compliance documents, benchmarking tools or codes of conduct*, such as the PRI, specific ILO conventions or the UN Global Compact, against which compliance should be monitored, assessed and reported, but otherwise allow the asset manager to exercise professional discretion to decide what ESG considerations to monitor and how to monitor and assess compliance and non-compliance, and the weight to give compliance or non-compliance with each ESG consideration and such considerations cumulatively.

Distinguishing ESG integration from traditional ethical investment approaches[44]

A further reason for embedding ESG language in investment management contracts is to avoid confusion between the *mainstream* investment approach that integrates ESG considerations and traditional negatively screened ethical investment approaches. As the Freshfields Report makes clear, ESG considerations do not limit the tools available to pension funds and asset managers to assess investments but *add powerful economic assessment and valuation tools to the existing investment tools to improve investment decision-making*. The object of ESG incorporation into mainstream investment decision-making therefore is not to exclude socially or ethically unacceptable stocks or shares but to focus a brighter light on the impact of all material considerations on investment value.

For example, armaments, such as cluster bombs, according to modern ESG assessment, would not be excluded by ESG considerations on the ethical ground of indiscriminate killing of innocent civilians and children but may be excluded because of breaches of international law by the armament company, or that a company making cluster bombs may not be seen to have a long term future.[45] Thus, divestment of shares or a decision not to invest in shares of an armaments company based on ESG considerations would fall squarely within the fiduciary duty of the pension fund to invest prudently. Divestment or investment on ethical grounds alone may likely fall within fiduciary duties only in particular circumstances, such as in the case of church or charity pension funds; however, there is much less certainty that it will do so in the case of company pension funds or pension funds which are not set up by a belief or cause-based institution.[46]

Finally, by incorporating ESG considerations into the Statement of Investment Principles or Investment Policy Statement and into the investment management contract, a clear link is established between the fiduciary duties of the pension fund trustees and the asset manager as the duty to act loyally—including following the investment mandate which is clearly a fiduciary duty—albeit a duty which has to be weighed with or against other fiduciary duties, such as the duty of fairness to all beneficiaries, the duty to act in the best (not necessarily short-term financial interests) of the beneficiaries, the duty to diversify to hedge risks, and the duty of prudence.[47]

Relevant commentary from Arnold & Porter

Consistent with the ESG integration approaches described above by Quayle Watchman Consulting, Arnold & Porter separately commented that:

'...many U.S. state treasurers and controllers have begun to show support for ESG integration approaches, particularly in regards to the risk of climate change, which is demonstrative of the growing support that ESG integration benefits from in the U.S.'

'...so long as ESG considerations are assessed within the context of a prudent investment plan, ESG factors can (and, where they implicate value, risk and return, arguably should) constitute part of the asset management process.'

As further discussed by Arnold & Porter in its commentary, which cites, among others, the

Freshfields Report:

'...it does not appear that current U.S. law forbids integrating ESG considerations into an asset manager's decision making process, so long as the focus is always on the value inuring to the beneficiaries and not on achieving unrelated objectives—even if positive collateral benefits result.'

C. Do institutional investment consultants and asset managers have a duty of care to proactively raise ESG considerations with their clients?

Quayle Watchman Consulting provided the following commentary.

Professionals must act as experts and advise their clients without being prompted or questioned by their clients on relevant and material issues. Institutional investment consultants ('investment consultants') and asset managers have a legal duty at common law to raise ESG considerations with their clients. Pension funds and other investors seek expert professional advice on investment risks and returns from investment consultants and asset managers. The courts accept, despite the widespread use of mathematical modelling, that investment is an art rather than a science and that there is a wide spectrum of opinion on investment which may be held by advisers without an adviser acting negligently.

An investment consultant or asset manager is a professional, however, and must act professionally. Whereas in the past, professional investment advisers may have been able to ignore ESG considerations or only to act reactively upon specific questioning by the client about ESG considerations, this can no longer be the case. There is now a very substantial body of evidence and professional opinion in the legal and investment communities that ESG is a mainstream investment consideration and, as such, ESG considerations must be taken into account in investment decision-making. This requires professional investment advisers to do due diligence and inform themselves of ESG considerations and how they affect different types of investment; for example, the impact of climate change and severe weather on the insurance and reinsurance industry or on penal road taxes and petrol duties on demand for automobiles. Equally, professional investment advisers must act proactively and raise the issue of the impact of ESG considerations on investment strategy and value (investment in Enron or Global Crossing to cite two well-known examples of companies with recognised governance defects).

In tendering for investment mandates, it would be expected that the investment consultant or asset manager would raise ESG considerations as an issue to be taken into account and discussed with the client even if the pension fund had not specified ESG considerations as material to the tender. If the investment consultant or asset manager fails to do so, there is *a very real risk that they will be sued for negligence* on the ground that they failed to discharge their professional duty of care to the client by failing to raise and take into account ESG considerations.

Investment consultants and asset managers have a duty of care to their clients under contract, the appointment mandate, and tort. The duty of care in tort is a recognised professional adviser giving advice and exercising professional discretion in the investing and divesting of assets. The duty of care as a professional is much more onerous than that of a non-professional as the person to whom the duty is owed is placing trust in the skills of the professional, and the professional is exercising discretionary powers far beyond those to be expected of a non-professional or layman.

As professional investment advisers, investment consultants and asset managers are under a *contract for services* rather than a *contract of service*. They are professional advisers to the client, not employees of the client; hence in exercising significant professional discretion (unless the professional investment adviser contracts out of that duty and even then it may be doubted if this can be done successfully), investment consultants and asset managers must be *proactive* rather than *reactive*. This duty would entail raising any matters proactively which might materially affect the client's or the beneficiaries' best interests. By implication and legally, investment consultants and asset managers also owe a duty of care to beneficiaries, through the fiduciary duties of the client, including raising proactively alternative forms of investment and the use of ESG considerations with the client as a means of, among others, better assessing investment potential or value.

D. Sample ESG provisions for investment mandates and investment management contracts

Arnold & Porter provided the following commentary in the context of current US law.

Based on draft ESG clauses for investment management agreements produced by the AMWG, Arnold & Porter produced sample investment objective and investment management contract provisions that take ESG considerations into account.

Relevant commentary from Quayle Watchman Consulting is stated below.

Rationale for ESG provisions

In order for asset managers to properly integrate environmental, social and corporate governance ('ESG') factors into their investment strategy in the asset management context in the United States, appropriate provisions should be included in the offering materials and contractual documents related to a particular collective investment vehicle or managed account (each, an 'account').[48] The goal of such ESG integration would be to enhance and supplement (and not replace) an asset manager's investment decision making process, rather than to avoid an evaluation of the potential merits of investing in certain companies based on their business involvement. While the latter approach may heighten portfolio risk (as the universe of potential investments is reduced based on screens or restrictions) and potentially run afoul of current applicable U.S. law, the former approach should generally be consistent with identifying the best possible investments from a risk-return framework, as required by current fiduciary law in the U.S.

In general, many investment management agreements ('IMAs') contain language linking the investment objective and strategy pursuant to which an account is to be managed to the relevant offering materials thereof and tend to be drafted in broad terms, giving an asset manager wide discretion in making investment decisions on behalf of such account. Consequently, as further discussed herein, it would be prudent to include ESG provisions in both the IMA and the offering materials (if any) of an account. ESG provisions may be incorporated into IMAs or other contractual documents of an account at inception, or subsequently added pursuant to the applicable amendment provisions.

Incorporating ESG provisions into an IMA (or other contractual documents) of an account as part of such account's investment strategy would provide:

(a) a contractual basis for asset managers to expressly integrate ESG factors into their investment decision-making process and in fulfilling their fiduciary duties in connection therewith;

(b) notice and information to potential and current investors about the ESG considerations that the asset manager will apply as part of its overall investment strategy; and

(c) a potential basis for investors in a particular account to hold an asset manager liable for breach of fiduciary and contractual duties if an asset manager fails or neglects to abide by the account's investment objective and strategy (including a failure or neglect to integrate ESG considerations).[49]

Sample ESG provisions

In order to assist asset managers in integrating ESG considerations compliant with applicable law into the relevant account documentation, we have prepared the sample investment objective and IMA provisions set forth on 'Annex A' hereto (the 'Sample Provisions') derived from draft clauses prepared by the Asset Management Working Group. The Sample Provisions have been drafted in a flexible manner so that they might not require revision in the event of changes in applicable law. The Sample Provisions are multi-purpose, and may be included in any number of account documents for a variety of types of accounts.[50] In addition, the Sample Provisions, as drafted, are not U.S.-specific and may, in theory, be incorporated in foreign Fund documents, as well.

Relevant commentary from Quayle Watchman Consulting

'These sample ESG provisions create clear and enforceable legal rights and duties. Quayle Watchman Consulting endorses the sample ESG provisions produced by Arnold & Porter and the incorporation of such ESG provisions in investment mandates and investment management contracts.'

Annex A

Arnold & Porter produced four sample ESG provisions, which were all endorsed by Quayle Watchman Consulting. All four sample provisions can be found in Appendix D.

Of the four, the AMWG deemed the following sample investment objective provision as the best:

<<<Client>>>'s investment objective is <<<investment objective>>>, provided that in pursuing such investment objective, <<<Asset Manager X>>> seeks to act in the best long-term interests of <<<Client>>>'s investors by taking into consideration environmental, social and corporate governance ('ESG') issues, to the extent permitted by law. <<<Asset Manager X>>> has signed the Principles for Responsible Investment ('PRI'). The PRI is an industry-focused initiative that promotes long-term responsible investment and share ownership, and the integration of material ESG issues into investment analysis. It is <<<Asset Manager X>>>'s intention to remain an active and engaged member of the PRI and meet any ongoing membership commitments (including the submission of an annual assessment questionnaire).

<<<Asset Manager X>>> is willing to make available to <<<Client>>> on request a copy of each assessment questionnaire that it submits to the PRI, as well as the PRI's analysis of its relative performance. Copies of the voting and engagement work undertaken within the context of the PRI are also available, upon request.

E. Recommendations to pension fund trustees

Quayle Watchman Consulting provided the following commentary.

In the absence of government legislation or regulations, codes of practice or guidance, the following must be achieved:

1. The pension fund trustees should be fully transparent about investment strategies pursued on behalf of beneficiaries, including to what extent such strategies incorporate ESG considerations.
2. The pension fund trustees should seek expert advice on their proposed investment strategy for each pension fund, including expert advice on how best to incorporate ESG considerations into investment analysis and decision-making processes.
3. The pension fund should state clearly in its Statement of Investment Principles or Investment Policy Statement and its investment management agreement (or the equivalent contract between the pension fund and its asset manager) the fund's guidelines on ESG considerations.
4. The pension fund should state clearly what ESG considerations are to be taken into account generally by the asset manager and, where appropriate or relevant, the weighting to be given by the asset manager to those ESG considerations which the pension fund wishes to be taken into account.
5. The pension fund should state the medium to long-term return period or periods over which the performance of the asset manager will be assessed. This should be linked to long-term incentives (e.g. bonuses and rewards) for meeting agreed performance targets. The pension fund should require the asset manager to report to it periodically (e.g. 6 to12 months) on the fund and on ESG requirement implementation. The pension fund and asset manager should agree on the form and standard of reporting most appropriate for the fund and its investments. The pension fund should require the asset manager to communicate its ESG expertise, including team qualifications and other resources, and how the asset manager ensures maintenance and development of such ESG expertise.
6. The pension fund should adopt and require the asset manager to adopt the Principles for Responsible Investment (PRI) and require the asset manager to demonstrate active involvement in the development of the PRI.
7. The pension fund should ensure that the asset manager appointed agrees to a periodic independent audit of their implementation of an investment mandate that takes into account ESG considerations.
8. As appropriate, the above recommendations should be contained in the offering materials of the pension fund and its investment management contractual mandates.

8

Part II

Survey of investment management consulting firms on the integration of ESG into the investment process

The framework of this pioneering survey has helped as the initial background information for a forthcoming more detailed investment consultant survey currently being conducted by the European Sustainable Investment Forum (Eurosif).

A. The role of investment consultants and the request for proposal process

The next section of this report summarises the key findings of the AMWG's survey of investment management consulting firms.

The main reason why the survey of investment consultants' views is so important is that they shape and transmit client demand to asset managers, so have significant influence over what asset managers do (or at least say they do).

Asset managers place considerable authority in the views of investment consultants as they advise potential clients such as pension schemes and foundations on which asset managers can best meet the requirements of their investment mandate. This intermediary role of investment consultants has emerged partly for legal reasons—pension fund trustees have a fiduciary obligation to represent pension fund beneficiaries; and partly for practical reasons—some lay trustees do not have the professional skills that are required to assess the investment processes of asset managers.

Investment consultants commonly use a client-specific assessment framework called requests for proposal (RFPs) to compare different asset managers on a like-for-like basis.[51] The RFP stipulates the key characteristics of the desired fund such as asset class, geographic scope, investment style, the outperformance target, and tracking error. It then presents a number of detailed questions, which are structured to tease out the asset managers' ability to meet their client needs. Put simply, the RFP sets the terms of the competition and asset managers focus considerable effort on their response.

While asset managers own companies on behalf of their clients and *can* influence how well these companies are run, whether these asset managers *do* use this influence to improve ESG performance largely depends on whether investment consultants and their clients assess asset managers' performance in this area.

When investment consultants believe that integrating ESG issues into investment analysis and engaging with companies in the portfolio influences the risk and return characteristics of the client's mandate, then the consultant will assess performance in this area. The consultant's analysis of how well ESG integration and engagement is executed will have some influence on the client's ultimate choice of asset manager. Over time, this demand signal to asset managers should increase the extent to which they compete in this area and, ultimately, increase the quality and quantity of ESG integration and engagement within the market overall.

B. Responses to the questionnaire

The AMWG approached the offices of a number of the world's leading investment management consulting firms ('consultants') in Asia, Europe and North America.

The purpose of this survey was to bring to light information regarding how leading investment consultants advise on ESG issues. The survey was designed by the AMWG (see Appendix C) and asks consultants to share their advice to clients on the integration of ESG issues into the investment process.

The six consultants who responded collectively represent almost USD 8 trillion in institutional, tax-exempt assets under advisement worldwide, or approximately 30% of the world's pension fund assets under management as of 30 June 2008 (International Financial Services, 2008).

We recognise that the survey method is biased as consultants with a business model which includes ESG issues, and therefore have something positive to say, are far more likely to respond than those that generally ignore these issues. Similarly, the sample size is clearly too small to draw representative conclusions for the entire investment consultant industry. However, we believe that these initial results are highly enlightening and enable some broad conclusions to be drawn about the investment consultant industry. Furthermore, the AMWG believes that other institutions and organisations committed to responsible investment can build on the framework of this pioneering survey.

The location of the responding offices ranged from Japan, the UK and the US. The worldwide institutional tax-exempt value of assets under advisement of each consultant who replied ranged from less than USD 700 million to almost USD 3.6 trillion in assets under advisement as of 30 June 2008 (Pensions & Investments, 2008).

The AMWG anonymised individual consultants and reported just the volume of worldwide institutional, tax-exempt assets under advisement.

However, with the permission of two respondents—Mercer Investment Consulting Inc. and Watson Wyatt Worldwide—the AMWG is featuring their full responses which, in its opinion, generally represent good practice among all consultants surveyed. Their responses can be found in Annex C.

The tabular analysis of responses is presented in Table 1 below:

Table 1: Overview of investment consultants' responses

	Consultant 1	Consultant 2	Consultant 3	Consultant 4	Consultant 5	Consultant 6
Consultant's geographic reach	Worldwide	Worldwide	Worldwide	US, UK, Asia	Worldwide	Asia
Worldwide institutional, tax-exempt assets under advisement 52	Tier 1	Tier 3	Tier 1	Tier 2	Tier 2	Tier 3
Level of ESG experience	World-leading	Moderately ESG-experienced	World-leading	Moderately ESG-experienced	Least experienced	Least experienced
Fiduciary duty						
Q1. Staff dedicated to ESG?	Medium-sized team	On demand	Large team	Small team	On demand	On demand
Q2. Witnessed increased ESG interest?	Yes	Slight	Yes	Slight	No	No
Q3. Consider ESG requisite in investment management?	Yes	Yes, but only corporate governance	Yes	Rarely	Rarely	No

Q4. Consider ESG requisite of fiduciary duty?	Yes, but only to extent it affects financial returns	Yes, but only to extent it affects financial returns	Yes, but only to extent it affects financial returns	Yes, but only to extent it affects financial returns	Yes, but only to extent it affects financial returns	No
Q5. Non-financial interests deserve consideration for fiduciaries?	Only for mission investors	Only for mission investors	Only for mission investors	Only for mission investors	No	No
Q6. Who is responsible for exercising ESG integration?	Trustees. Consultants only assist	Trustees. Consultants only assist	Trustees. Consultants only assist	Trustees. Consultants only assist	Government	Government
ESG criteria						
Q7. Which ESG criteria relevant for investment policy statement (IPS)?	Client decides	Best to leave IPS generic	Client decides. But best to leave IPS generic	Client decides	Client decides. Anti-social forces popular	Pollution and human rights
Q8. Can ESG be discharged solely through voting rights?	Yes, but this is just one alternative	Yes, but this is just one alternative	Yes, but this is just one alternative. Can be limiting	Yes, but this is just one alternative	Yes, but this is just one alternative	Yes, but this is just one alternative
Q9. Can ESG be discharged solely through engagement?	Yes, but this is just one alternative	Yes, but this is just one alternative	Yes, but this is just one alternative. Can be limiting	Yes, but this is just one alternative. Usually investment managers' job	Yes, but this is just one alternative	No
Q10. Does ESG fiduciary duty include positive/ negative screening?	Mainly for mission investors	Yes, but this is just one alternative	Mainly for mission investors	Yes, but this is just one alternative	Yes, but this is just one alternative	Yes, but this is just one alternative
Evaluating competence						
Q11. Do you evaluate managers' ESG abilities?	Yes	No, but under consideration	Yes	No, but under consideration	No	No
Q12. How do you evaluate ESG competence for mission investment mandates?	Detailed standard internal assessment	Client decides	Detailed standard internal assessment	Ad hoc criteria	Ad hoc criteria	No evaluation
Proxy voting						
Q13. Do you investigate managers' record for proxy voting and engagement?	Routinely for mandated investment. Otherwise only on client demand.	Only on client demand	Yes for all investment	Routinely for mandated investment	No	No
Requests for proposal						
Q14. Do you routinely include ESG questions in all RFPs?	Don't use RFPs because internal database contains this information	Only on client demand	Only on client demand. However, recently added this information to internal database	Only on client demand	No	No
Governing ESG in mandates						
Q15. Do managers' typical timeframes for review discourage ESG?	Sometimes. We advise for longer time frames	No. Don't rely on timescales	Sometimes. We advise for longer time frames	Sometimes. We advise for longer time frames	No, not a problem	Don't know
Q16. Do managers' incentive structures affect ESG strategies?	Sometimes. We advise rewarding long-term performance	Neutral	Sometimes. We advise rewarding long-term performance	No answer given	Neutral	Don't know

Q17. Do tracking error limits or index-referenced mandates affect ESG strategies?	Penalise ESG integration. Prefer absolute return	Penalise ESG integration	Penalise ESG integration. Prefer absolute return	Penalise ESG integration	Neutral	Don't know
Legal language						
Q18. Should ESG legal language be incorporated into investment management contracts between institutional investors and managers?	If client requests but risk that language could be restrictive	Currently no. Risk that language could be restrictive	If client requests but risk that language could be restrictive	If client requests	If client requests but risk that language could be restrictive	Don't know
Q19. Should ESG language be part of IPS?	Only on client demand	Yes, required by law	Only on client demand	Only on client demand	Only on client demand	Don't know

C. Detailed description of investment consultants' responses

1. Relevance of ESG to financial performance

Consultants were asked about whether they considered the integration of ESG matters a requisite aspect of investment management or a part of trustees' fiduciary duties. There was no consensus in response to this question although responses given were strongly correlated with the level of ESG experience.

Two consultants responding from the Japanese offices of an international and a domestic-based firm respectively (hereafter, 'Japanese consultants') showed some confusion about the meaning of ESG integration. These firms represented 12% of total assets under advisement in the sample. They viewed ESG as an ethical screen on investment. For this reason, Japanese consultants were reluctant to institute ESG policies into clients' investment principles and did not consider it important in the investment management process. Japanese consultants also exhibited the least experience with ESG integration within their organisation among those who responded.

Two consultants based in the UK and US offices respectively of international consulting firms with moderate ESG experience (hereafter, 'moderately ESG-experienced consultants') appeared at one level to appreciate that ESG integration was fundamentally linked to financial performance. These firms represented approximately 18% of total assets under advisement in the sample. To a certain extent, they were comfortable with investment managers giving consideration to ESG factors in cases where institutional investors had an appetite for this investment philosophy. Some consultants encouraged clients to ask questions about an investment manager's ESG expertise because this was considered a strong marker for a manager's broader investment research capability:

'This dialogue with fund managers may be inherently useful in understanding which managers are more alert to changing dynamics and finding stocks with potential higher future earnings.'

However, these consultants also demonstrated a lack of conviction in ESG integration when pressed on whether clients should integrate ESG into their investment policy statements. The concern was that ESG integration could in some cases lead to poorer financial performance, thereby suggesting that they continued to view ESG integration as an ethical or mission-related preference, rather than a fundamental tool for fine-tuning financial analysis and enabling outperformance.

For example, one UK-based consultant in an international, moderately ESG-experienced firm argued that ESG integration should not be a default position written into a fund's Statement of Investment Principles because there were a series of potential conflicts with trustees' fiduciary duties. Under a Defined Benefit Pension Scheme, they argued that if an ESG-themed portfolio resulted in moderate or poor performance then the financial impacts will hit employers first in the form of increased contributions, or by the active membership in the form of increased employee contributions. This could result in a higher risk portfolio for employers, and would therefore need to be considered in light of the Employer Covenant. This was seen as less of a problem for a Defined Contribution Pension Scheme because the scheme members take direct responsibility for their own investment choices.

However, consultants based in the UK and US offices respectively of the world's leading consultancies by size of assets under advisement and ESG experience understood that ESG integration (hereafter, 'world-leading consultants') was fundamentally about *improving* financial performance of assets under management as opposed to exposing them to greater risk. These firms represented 70% of total assets under advisement in the sample.

These consultants both argued that there was evidence that ESG factors materially benefited long-term investment strategies (for example, the selection of long-term long-only equities) as opposed to short-term investments. However, they pointed out that the strength of this relationship varied across industry sectors, geographic regions, and asset classes.

As a result, they supported integrating ESG into clients' investment policy statements but advised against developing issue specific statements since ESG variables change over time and across asset classes. It was therefore recommended that policies be drafted broadly to capture the dynamic impact of ESG considerations on investment returns across sectors and over time.

2. Who is responsible for ESG in the investment chain?

Five out of the six consultants who responded believed that trustees have a responsibility to communicate their appetite for ESG considerations to investment managers and consultants.

However, only three consultants also mentioned that consultants themselves have a responsibility to raise ESG considerations with their clients. And of the three, only one was explicit in saying that consultants have the responsibility to raise ESG considerations with trustees:

'It is the responsibility of Consultants and pension managers to raise the issue with Trustees and Employers in addition it is also their responsibilities along with Scheme lawyers to assist the Trustees with establishing whether their ESG policies are in the interest of the beneficiaries.'

The two other consultants viewed the responsibility of consultants either as a secondary or reactive role.

This is a surprising finding and it indicates that although ESG integration has been growing in prominence among consultants, much more needs to be done to institute ESG integration discussions as a regular feature in consultant-trustee dialogue. Consultants should be raising ESG issues with their clients rather than waiting for their clients to flag the issue. To wait for trustees or managers to raise this issue maybe a breach of consultants' professional duty to their clients.

The opinion of beneficiaries towards ESG integration in investment decision-making was not widely raised. Only two consultants (one moderately ESG-experienced consultant, and one world-leading consultant) mentioned beneficiaries at all when asked where the responsibility for exercising ESG resided.

One consultant had a clear view that trustees should be acting in the interests of beneficiaries:

'The Trustees of the Scheme should demand ESG integration once they have established it is in the interests of the beneficiaries.'

The other consultant placed more emphasis on the role of trustees and pension managers:

'Ultimately the responsibility rests with Trustees, pension managers and to some extent beneficiaries.'

3. Consultants' capacity to advise on ESG

Two consultants who responded currently had world-leading institutional capacity to advise on ESG integration. These institutions had established teams worldwide with full-time consultants employed to focus on responsible and sustainable-themed investment. These teams had come into existence over the last five years.

The two Japanese consultants exhibited the lowest level of capacity to advise, with one consultant stating that they had no internal capacity to advise on ESG issues, while the other consultant stating that advice was provided on client demand.

The moderately ESG-experienced firms only provided ESG integration advice on a client demand basis. However, they stated that they were in the process of building up their expertise.

Two-thirds of firms who responded, representing 88% of total assets under advisement in the sample, observed a growing interest in ESG investment advice among their client base. However, there was a variety of reasons given for this growth of interest:

- Evidence of a material connection between ESG and investment performance;
- A desire to investigate whether managers address ESG in their investment process; and
- Prevalence of mission-related investors with an ESG goal.

Although interest in ESG integration is steadily growing, there is a need for greater education of trustees and managers about what ESG integration actually entails. There is some evidence that trustees see ESG integration as an ethical investment preference rather than as a financial analytical tool. Therefore, they are not always conscientious in selecting managers with strong ESG analytical expertise. Likewise, managers are not always zealous in acquiring and promoting ESG capabilities.

This is illustrated in the comments from the UK office of one moderately ESG-experienced consultant which stated that their clients saw ESG as a form of voluntary compliance or 'tick the box' issue rather than a fully integrated valuation method:

'… it is usually low on the list of priorities when considering and selecting investment managers. Most managers usually give an answer which satisfies Trustees who can then "tick a box." Few Trustee bodies are interested / or confident in probing their managers ESG policies in depth.'

The lack of manager expertise in ESG integration appears to be a serious deficiency even if situations when a client wants to access ESG integration services. This is evident in the following statement by one world-leading ESG consultant:

'Not all managers, across geographies, asset classes and styles have the inclination or ability to abide by such [ESG] language and it might be dangerous to include it otherwise (sic).'

Notwithstanding the strong growth in interest in ESG integration over the last five years, the investment community of managers, consultants, and trustees must continue to build ESG-related expertise to strengthen their financial toolbox.

4. How should ESG considerations be exercised?

All of the consultants agreed that there was no single or primary method for exercising ESG-related fiduciary duties. A combination of a variety of possible methods was raised:

- Exercising voting rights attached to equities
- Engagement activity of varying intensities
- Specific investment decisions, for example:
  - > Adjust stock and sector portfolio weightings
- Moderated outcomes of investment analysis, for example:
  - > Adjust the investment perspective on company management and their ability to execute corporate strategy
  - > Adjust the investment perspective on the validity of financial metrics such as fair value, price targets, future earnings, profitability, liabilities, etc.

Despite the variety of options available, in practice, some advantages and disadvantages were identified for each of the options. It was therefore advised that a combination of strategies might be most appropriate based on the clients' needs. These are summarised in Table 2 below.

Table 2: Strategies to exercise ESG considerations

Strategy	Issue raised	Comment
Exercise of voting rights	▪ A client may not hold enough voting rights to make a difference. ▪ Voting rights do not exist for all types of assets.	*'…voting rights do not exist across all asset classes and do not have the same impact across all geographies in effecting corporate change.'*
Direct engagement with corporate directors	▪ In practice, this does not mean that directors will respond to requests made.	*'Engagement does not guarantee results in itself and traditionally has been limited to governance issues, more than social and environmental considerations.'*
Buy/sell strategies which implement positive or negative screening	▪ Many pension schemes in the UK now implement their equity exposures through passive funds and therefore ESG filters would not apply. ▪ May increase the risk profile of the portfolio.	*'…screening could bias the portfolio considerably. The most quoted bias would be towards small cap growth companies with a short history. From an investment perspective this may not necessarily be advantageous.'*

5. Procedures for selecting investment managers

Consultants were asked a number of questions on their standard procedures for evaluating the performance and ability of investment managers to manage pension funds and other institutional investments. Specific procedures considered were:

- Evaluating the competencies of investment managers;
- Reviewing the proxy and engagement record of investment managers; and
- Requests for proposal (RFPs).

Evaluating the ESG competence of managers

Consultants were asked whether they evaluate an investment manager's ability to integrate ESG factors into valuation or portfolio composition as part of their overall assessment of investment managers, regardless of whether a mandate calls for specific socially responsible investment, environmental investment, ethical investment, sustainable investment, and so forth.

At present, only one consultant routinely carried out ESG ratings in parallel with their overall investment rating. The weighting given to this rating, however, was left to clients to decide. The criteria used for evaluating was described as follows:

'We look at how the ESG considerations impact idea generation, portfolio construction, management and implementation.'

The ESG-experienced consultants were currently incorporating an assessment of managers' ESG integration capabilities into the routine manager research process. However, there was some uncertainty on how to measure managers' ESG aptitude:

'We are in current discussions about how to best try and assess such abilities. The challenge is that there is a great amount of subjectivity to such an assessment and the distinct priorities and values of clients are bound to lead to a diverse range of views of any given managers' incorporation of ESG factors. We are exploring how to best come up with an objective baseline measure for a manager. Developing a relative measure is more problematic.'

The two Japanese consultants with a combined value of approximately USD 1 trillion in assets under advisement stood out from the other consultants by stating that they did not evaluate the ESG competence of managers *and* were not in the process of routinely introducing such a process in the near future. ESG competence was also considered on a client demand basis, and Japanese consultants revealed that there was relatively weak demand for such advice.

Proxy voting and engagement record of managers

Consultants were asked whether they routinely investigate the proxy voting and engagement record of asset managers regarding environmental and social issues.

One consultant stated that they routinely investigated these issues as part of their ESG rating which applied to all investment managers and all strategies.

Three consultants stated that they carried this out upon client demand in the case of mainstream mandate funds, or if the relevant documents were provided in *'the regular exchange of documents and information with managers.'* Of these respondents, two routinely investigated the proxy voting practice of investment managers in relation to sustainable investment funds.

Finally, there was one consultant who stated that they do not investigate proxy voting of investment managers.

Requests for proposal (RFPs)

Consultants were asked whether they habitually include the following questions in RFPs to investment managers:

- What is your ESG policy?
- How do you integrate ESG into investment management advice?
- What is your ESG expertise or competence?

Four of the six consultants used RFPs. These consultants were the four who had the relatively least amount of ESG-related expertise. In each case, these consultants stated that they would only include ESG-related questions if their client had a specifically mandated fund. This suggests that consultants with less ESG expertise were generally driven by client demand in selecting managers rather than actively seeking out managers with ESG integration competence.

On the other hand, the two leading ESG consultants did not use RFPs to select managers. Instead, they relied on their own internal databases of global investment managers for this information. In constructing these databases, both consultants indicated that they obtained all necessary ESG information through in-depth research processes and ongoing dialogue.

'…we recently sent a request for information to all managers in our Global Investment Manager Database requesting ESG integration information as part of our due diligence for clients.'

6. Barriers to ESG in the financial management process

Consultants were drawn on their view as to whether various aspects of the financial management process were biased against the integration of ESG.

There was no strong consensus on whether this was the case. One consultant felt that the strongest influence on ESG considerations was *'government restrictions and public opinion'* rather than any culture traditions within financial management.

Nonetheless, three issues in particular were considered:

- Standard investment timeframes used by managers;
- Incentive structures for managers; and
- Use of tracking error limits and index-referenced mandates.

Investment timeframes of managers

Consultants were asked whether they thought the typical timeframes for review and evaluation of managers' financial performance discouraged ESG integration.

There was some disagreement on this issue. Half the consultants felt that the timeframe was not a problem in evaluating managers' financial performance. Partly, this was because they advised clients to review managers on criteria which were not related to a timescale, as highlighted below:

'A typical client will review managers under the following circumstances.

1. *When the client loses confidence in the managers' ability to achieve the objective; or*
2. *When there is a change in strategy.'*

However, the world-leading consultants responding from the UK and US offices respectively felt that timeframes could pose a problem. They felt that placing too much emphasis on short-term investment performance was detrimental to the pursuit of long-term performance goals. It was in the domain of long-term performance that ESG factors were believed to have the biggest impact on investment returns.

These consultants were also in agreement in advising their clients to evaluate manager performance over a longer timeframe. As an example, one consultant stated:

'We typically recommend a longer time frame for evaluating manager performance (at least 3 years) within a portfolio, particularly with public securities.'

Although there was divided opinion on the importance of time horizons in evaluating managers' performance, leading international consultants with experience in ESG advised clients to look for long-term performance where ESG analytics are more likely to play out.

Incentive structures for rewarding managers' performance

Consultants were also asked whether incentive structures for investment managers were neutral towards or penalised the integration of ESG factors.

Fee structures for managers vary significantly between fixed management fees, performance related fees, or a combination of both.

Most consultants felt that incentive structures had a neutral effect on ESG considerations where there were fixed management fees. This is because managers would be remunerated regardless of their performance.

On the other hand, where incentives were structured in favour of short-term performance targets then ESG integration would be penalised because *'ESG factors… typically play out over [the] medium to longer term.'*

It was therefore advised that clients rely on a well-structured performance fee to reward managers on a basis which suited clients' needs. Typically, consultants advised in favour of a long-term performance timeframe:

'[This consultant] believes that well structured performance related fees, with appropriate high water marks and time horizons, can be beneficial to aligning the interests of clients and investment managers and are therefore desirable…

'However, performance fees should be appropriately structured to avoid investment managers over emphasising short-term performance as this would be unlikely to incentivise them to consider ESG factors which typically play out over [the]medium to longer term.'

Tracking error limits and index-referenced mandates

All consultants generally agreed that tracking error limits and index-referenced mandates penalised the integration of ESG into investment decisions.

A number of reasons were given for why this might be the case. For example, one consultant pointed out that the composition of indices as a result of sector specialisation or history has been typically weighted towards industries with large levels of pollution.

For example, the FTSE All Share Index for the UK has an above average allocation to mining and extraction companies which do not have the best environmental record. It was argued therefore that the indices may better track firms which would not be included in an ESG-integrated portfolio.

The two leading international consultants with ESG experience argued that portfolios managed on an absolute return basis had greater freedom to implement insights from ESG considerations because they would not be constrained by the benchmark. These consultants felt that it would be beneficial for managers to adopt a longer time horizon in investment decisions and an acceptance of greater deviation from the index:

'The practice of monitoring and evaluating short-term performance against a benchmark likely precludes integration of ESG by fund managers, as these factors may take some time to impact on valuations and the risk of deviating too far from the index on the basis of ESG considerations might be considered too risky.'

There was a suggestion that globally accepted ESG indices across asset classes would be beneficial. Although there might be some debate as to whether using an ESG index would be appropriate for assessing performance, it was pointed out that such indices would help quantify the impact of ESG policies on returns over various time periods.

One moderately-experienced consultant responding from UK offices anticipated that the relative outperformance/underperformance relationship between ESG and mainstream indices would depend on the investment timeframe chosen:

'We would expect that over different time periods the relevant [ESG] indices would outperform and underperform the more conventional indices.'

The implication of this statement is that ESG indices might outperform mainstream indices over the long term but underperform mainstream indices in the short term.

7. Incorporating ESG contractually and in investment policy statements

Finally, consultants were asked whether they believed that legal language on ESG integration should be part of investment management contracts between institutional investors and investment managers, or as part of investment policy statements. All consultants indicated that they believed incorporating ESG into legal language was only appropriate where the client had explicitly expressed ESG requirements and objectives as part of their fund objectives.

However, where a fund did not have a mandated objective it was thought that ESG language should not be included as a default because it was thought that investment managers might not always have the capacity to execute such requirements across all geographies, asset classes and strategies. Furthermore, it would limit the investment universe for capturing excess returns:

'…we believe we have some ways to go before [ESG integration in investment policies] can be implemented without severely limiting the investment options for an institutional investor.'

It was acknowledged nonetheless that some institutions were pursuing such legal language for mandated funds, and others were opening dialogues on this matter with their existing investment managers.

Specifically on the issue of integrating ESG into investment policy statements, only one of the two investment consultants responding from offices in the UK mentioned the legal requirement to disclose ESG-related matters in policy statements in accordance with the Occupational Pension Schemes (Investment) Regulations 2005.

This Regulation states that:

(3) A statement of investment principles must be in writing and must cover at least the following matters:

(a) …

(b) their policies in relation to—

- (i) the kinds of investments to be held;
- (ii) the balance between different kinds of investments;
- (iii) risks, including the ways in which risks are to be measured and managed;
- (iv) the expected return on investments;
- (v) the realisation of investments; and
- (vi) 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

(c) their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to the investments.

The following standard Statement of Investment Principles was provided as an example of this language in operation:

'Social, Environmental or Ethical Considerations

'The Trustees do not currently have an active policy in place with regard to the extent to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments. These matters are however kept under review by the Trustees, in consultation with their investment consultant and investment managers.

'Activism and the Exercise of the Rights Attaching to Investments

'The Trustees do not currently have a specific policy in relation to the exercise of the rights (including voting rights) attaching to investments. These matters are however kept under review and the Trustees are aware of the policy towards corporate governance adopted by their investment managers and receive regular reports on their activity.'

D. Summary analysis of investment consultants' responses

1. Apparent problem with lack of ESG integration in the consultant industry.

Although respondents are some of the world's most globally integrated leaders in investment consulting, the views of one regional office did not always reflect the views of other offices, even within the same consulting firm. This suggests that institutionalising ESG considerations is still relatively nascent in the consultant industry.

2. Discernable change in demand for ESG-inclusive services since the advent of the PRI in 2006.

Over the last five years, two respondents with world-leading institutional capacity to advise on ESG integration had established teams with full-time consultants focusing on responsible and sustainable-themed investment. This suggests asset owners' increasing demand for ESG-inclusive consulting services.

3. Some confusion between ESG integration and traditional ethical investment approaches.[53]

Some consultants still appear to confuse ESG integration with traditional negatively screened ethical investment approaches. Some consultants were concerned that ESG integration could in some cases lead to poorer financial performance, thereby suggesting that they continued to view ESG integration as an ethical or mission-related preference, rather than a fundamental tool for fine-tuning financial analysis and enabling outperformance.

Per Quayle Watchman Consulting's commentary cited earlier in this report:

'As the Freshfields Report makes clear, ESG considerations do not limit the tools available to pension funds and asset managers to assess investments ***but add powerful economic assessment and valuation tools to the existing investment tools to improve investment decision-making****. The object of ESG incorporation into mainstream investment decision-making therefore is not to exclude socially or ethically unacceptable stocks or shares* ***but to focus a brighter light on the impact of all material considerations on investment value.****'*

Per Arnold & Porter's commentary cited earlier in this report:

'The goal of such ESG integration would be to ***enhance and supplement*** *(and not replace) an asset manager's investment decision making process, rather than to avoid an evaluation of the potential merits of investing in certain companies based on their business involvement. While the latter approach may heighten portfolio risk (as the universe of potential investments is reduced based on screens or restrictions) and potentially run afoul of current applicable U.S. law, as further described herein, the former approach should generally be consistent with* ***identifying the best possible investments from a risk-return framework****, as required by current fiduciary law in the U.S.'*

'...so long as ESG considerations are assessed within the context of a prudent investment plan, ESG factors can (and, ***where they implicate value, risk and return****, arguably should) constitute part of the asset management process.'*

4. Consultant industry has not yet sufficiently developed measures to assess asset managers' competence on ESG integration and engagement.

Only one consultant—Mercer—routinely carried out ESG ratings in parallel with their overall investment rating. This needs to become the industry norm. The weighting given to this rating, however, was left to clients to decide. The criteria used for evaluating was described as follows:

'We look at how the ESG considerations impact idea generation, portfolio construction, management and implementation.'

Some consultants were currently incorporating an assessment of managers' ESG integration capabilities into the routine manager research process. However, there was some uncertainty on how to measure managers' ESG aptitude:

'We are in current discussions about how to best try and assess such abilities. The challenge is that there is a great amount of subjectivity to such an assessment and the distinct priorities and values of clients are bound to lead to a diverse range of views of any given managers' incorporation of ESG factors. We are exploring how to best come up with an objective baseline measure for a manager. Developing a relative measure is more problematic.'

However, it appears that measures to assess managers' ESG competence are developing and forthcoming, and if done well, it will be a very positive step in advancing the quality and quantity of ESG integration and engagement services in the market.

5. Conflict with Quayle Watchman Consulting's legal advice on the professional duty of institutional investment consultants and asset managers to proactively raise ESG considerations with their clients.

Five out of the six consultants who responded believed that trustees have a responsibility to communicate their appetite for ESG considerations to investment managers and consultants. However, only three of the six consultants also mentioned that consultants themselves have a responsibility to raise ESG considerations with their clients. And of the three, only one was explicit in saying that consultants have the responsibility to raise ESG considerations with trustees. The two others mentioned the responsibility of consultants either as a secondary or reactive role.

Therefore, except for one, all responses are inconsistent with Quayle Watchman Consulting's commentary cited earlier in this report:

'In tendering for investment mandates, ***it would be expected that the investment consultant or asset manager would raise ESG considerations as an issue to be taken into account and discussed with the client even if the pension fund had not specified ESG considerations as material to the tender.*** *If the investment consultant or asset manager fails to do so, there is* ***a very real risk that they will be sued for negligence*** *on the ground that they failed to discharge their professional duty of care to the client by failing to raise and take into account ESG considerations.'*

'As professional investment advisers, investment consultants and asset managers are under a ***contract for services*** *rather than a* ***contract of service****. They are professional advisers to the client, not employees of the client; hence in exercising significant professional discretion (unless the professional investment adviser contracts out of that duty and even then it may be doubted if this can be done successfully), investment consultants and asset managers must be* ***proactive*** *rather than* ***reactive****. This duty would entail raising any matters proactively which might materially affect the client's or the beneficiaries' best interests. By implication and legally, investment consultants and asset managers also owe a duty of care to beneficiaries, through the fiduciary duties of the client, including* ***raising proactively alternative forms***

of investment and the use of ESG considerations *with the client as a means of, among others, better assessing investment potential or value.'*

6. Conflict with Quayle Watchman Consulting's legal advice on the necessity of embedding ESG language in investment management contracts, as well as in Statements of Investment Principles or Investment Policy Statements.

All the consultants indicated that they believed incorporating ESG into legal language was only appropriate where the client had explicitly expressed ESG requirements and objectives as part of their fund objectives (one consultant stressed the importance of the issue, but did not provide an answer).

This is inconsistent with Quayle Watchman Consulting's commentary cited earlier in this report:

'…it is ***necessary*** *for investment management agreements or the equivalent contract between pension funds and asset managers to use ESG language in order to clarify the expectations of the parties to the contract. In particular, it is important that it is made absolutely clear to beneficiaries, pension fund trustees and asset managers that ESG is regarded as a mainstream investment consideration.'*

'A further reason for embedding ESG language in investment management contracts is to ***avoid confusion*** *between the mainstream investment approach that integrates ESG considerations and traditional negatively screened ethical investment approaches.'*

'…by incorporating ESG considerations into the Statement of Investment Principles or Investment Policy Statement and into the investment management contract, ***a clear link is established between the fiduciary duties of the pension fund trustees and the asset manager*** *as the duty to act loyally—including following the investment mandate which is clearly a fiduciary duty—albeit a duty which has to be weighed with or against other fiduciary duties, such as the duty of fairness to all beneficiaries, the duty to act in the best (not necessarily short-term financial interests) of the beneficiaries, the duty to diversify to hedge risks, and the duty of prudence.'*[54]

'The pension fund should ***state clearly*** *in its Statement of Investment Principles or Investment Policy Statement and its investment management agreement (or the equivalent contract between the pension fund and its asset manager)* ***the fund's guidelines on ESG considerations.'***

In addition, per Arnold & Porter's commentary cited earlier in this report:

'Incorporating ESG provisions into an IMA (or other contractual documents) of an account as part of such account's investment strategy would provide:

(a) *a* ***contractual basis*** *for asset managers to expressly integrate ESG factors into their investment decision making process and in fulfilling their fiduciary duties in connection therewith;*

(b) ***notice and information*** *to potential and current investors about the ESG considerations that the asset manager will apply as part of its overall investment strategy; and*

(c) *a* ***potential basis*** *for investors in a particular account to hold an asset manager liable for breach of fiduciary and contractual duties if an asset manager fails or neglects to abide by the account's investment objective and strategy (including a failure or neglect to integrate ESG considerations).'*[55]

7. ESG-related disclosure laws are still evolving, and compliance must meet both the spirit and letter of the law. Policymakers and civil society have crucial roles to play.

On the issue of integrating ESG into investment policy statements, only one investment consultant responding from offices in the UK mentioned the legal requirement to disclose ESG-related matters in policy statements in accordance with the Occupational Pension Schemes (Investment) Regulations 2005.

The following standard Statement of Investment Principles was provided as an example of this language in operation:

'Social, Environmental or Ethical Considerations

'The Trustees do not currently have an active policy in place with regard to the extent to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments. These matters are however kept under review by the Trustees, in consultation with their investment consultant and investment managers.

'Activism and the Exercise of the Rights Attaching to Investments

'The Trustees do not currently have a specific policy in relation to the exercise of the rights (including voting rights) attaching to investments. These matters are however kept under review and the Trustees are aware of the policy towards corporate governance adopted by their investment managers and receive regular reports on their activity.'

The UK SRI Disclosure Regulation

'From 3rd July 2000, a new amendment to the Pensions Act 1995 requires the trustees of occupational pension schemes to disclose their policy on socially responsible investment in their Statement of Investment Principles (SIP)' (UKSIF, 2000).

The standard SIP provided by the consultant is disappointing as it meets the letter but not the spirit of the law. This suggests that some 10 years after the implementation of the UK SRI Disclosure Regulation, the time may have come to review how its effectiveness could be improved with additional reporting and disclosure requirements that will supersede mere 'tick box' compliance.

It is essential to monitor such legal developments in all jurisdictions and to be vigilant in ensuring that compliance is carried out as an intrinsic exercise of good governance.

In this vein, policymakers and civil society have crucial roles to play in helping create responsible and sustainable capital markets that are fit for purpose:

- Global capital market policymakers should make it clear that advisors to institutional investors have a duty to proactively raise ESG issues within the advice that they provide, and that a responsible investment option should be the *default* position. Responsible investment, active ownership and the promotion of sustainable business practices should be a routine part of all investment arrangements, rather than the optional add-on which many consultants appear to treat it as.
- More broadly, policymakers should ensure prudential regulatory frameworks that enable greater transparency and disclosure from institutional investors and their agents on the integration of ESG issues into their investment process, as well as from companies on their performance on ESG issues.
- Civil society institutions should collectively bolster their understanding of capital markets such that they can play a full role in ensuring that capital markets are sustainable and delivering responsible ownership.

9

Part III

Practical developments on the integration of ESG into the investment process

In today's complex financial markets, many individuals rely on institutional investors to invest on their behalf. Individuals place a great deal of trust in these funds to increase the value of their investments over time. Both civil law and common law legal systems recognise the creation of wealth for beneficiaries as the paramount duty for institutional investment fund trustees. However, as the preceding sections have asserted, it is becoming increasingly clear that to be able to sustain their wealth creation role, institutional investors also have an important role in supporting the creation of a more sustainable economy.

In order to help institutional investors contribute to improved business sustainability, this section of the report features recent developments and studies that provide insight into the extent to which institutional investors have adopted longer-term investment strategies, and practical steps on how they can integrate ESG considerations into the investment process going forward.

In addition, a review of legal developments on fiduciary duty and ESG issues since, and including, the Freshfields Report is provided in Appendix A.

1. Are institutional investors moving towards longer-term investment strategies?

While the law regarding fiduciary duty has changed very little in the years since the Freshfields Report, there have been a number of practical developments indicating that many institutional investors are beginning to see their fiduciary duty as allowing for, or even requiring, a more sustainable investment approach.

The Norwegian Government Pension Fund – Global

In 2008, the Norwegian government carried out an evaluation of the ethical guidelines for the Government Pension Fund – Global ('the Fund'), one of the largest funds in the world. The ethical guidelines are based on the government's belief that the country's petroleum wealth *'must be managed so as to generate a sound return in the long term, which is contingent on sustainable development in the economic, environmental and social sense,'* and that the Fund '*should not make investments which constitute an unacceptable risk that the Fund may contribute to unethical acts or omissions, such as violations of fundamental humanitarian principles, serious violations of human rights, gross corruption or severe environmental damages'* (Norwegian Ministry of Finance, 2008). A public hearing on the ethical guidelines, designed to maintain support for and strengthen the guidelines, was completed in early 2009.

The results of the evaluation were presented by the Ministry of Finance on behalf of the Norwegian Government to the Norwegian Parliament on 3 April 2009, in the yearly report on the management of the Government Pension Fund. In connection with the publishing of this report, the Norwegian Ministry of Finance issued a press release[56] underscoring the role of the Fund as a responsible investor:

'The Government wants the Fund to act as a responsible investor, which means that the Fund shall be managed in a way that promotes better functioning, legitimate and efficient markets and

sustainable development in the broadest sense' and that *'[o]ne of the changes being introduced now is adoption of a broader perspective: consideration of environmental and social aspects and good corporate governance are going to be integrated to a greater extent as relevant factors in all aspects of the management of the Fund.'*

It goes on to say that *'[t]he Government wants the Government Pension Fund – Global to take an even stronger stance in its role as a responsible investor. The Ministry of Finance is signing up to the UN Principles for Responsible Investment (PRI) and is going to participate directly in other international initiatives, so as to be involved in putting on the agenda how the concerns of environmental and social responsibilities and good corporate governance can be safeguarded by financial investors.'*

In another press statement given on the same day,[57] and while taking a closer look at the repercussions of the financial crisis, the Norwegian Minister of Finance stressed the long-term investment strategy of the Fund:

'The Government Pension Fund is the largest fund in Europe, and has a very long-term strategy. We are not short-term speculators that have to realize losses in the short-term.'

Finally, in June 2009, in her speech at the Government Pension Fund's Investment Strategy Summit, *'Investing for the long run,'* the Norwegian Minister of Finance articulated the importance of addressing climate change risks and opportunities:[58]

'Another important risk factor for us all, be it as citizens of the world or part-owners in a fund with a very long investment horizon, is climate change. Climate change can have wide-ranging consequences for the world economy and financial markets.

'This government takes climate change seriously—also in the management of the Government Pension Fund. As a broadly diversified and long-term investor, the fund has an interest in avoiding negative economic and financial repercussions of climate change.

'In this year's report [to the Norwegian Parliament on the management of the Fund] we detailed plans to establish a new environmental investment programme, and to initiate a broad study of the possible effects of climate change on global capital markets. We also want to strengthen the focus on issues related to climate change in Norges Bank's work on engaging with companies. Together, it is my hope that these measures will position the fund among the leading funds internationally in this area, and that we will inspire other investors to address the issue of climate change.'

The long-term investment club

French institutional investors have also been particularly active in promoting longer-term performance. In April 2008, the French state-owned bank, Caisse des Dépots et Consignations (CDC) established the Long-Term Investors Club (Wheelan, 2008a), of which the founding members are CDC, Cassa depositi e prestiti, the European Investment Bank, and KfW Bankengruppe (CDC, 2009). The Club aims *'to bring together major worldwide institutions including sovereign wealth funds, public sector retirement funds, private sector pension funds, economists, financial policy makers, and regulators to assert their common identity as long-term investors, to open the way to greater cooperation between us all and to deliver the message that fostering the right conditions for long-term investment will be an important element in promoting growth and economic stability.'*

The preamble of the Club's charter outlines seven key principles that members agree on, including two principles that refer to ESG issues: *'We believe that long term investment must support social and environmental improvement; therefore we will invest in accordance with the internationally recognized social and environmental responsibility policies'* and *'We believe that Environmental,* *Social and Governance issues can affect the performance of investors' portfolios in a long term perspective and that taking in[to] account these issues may better align investors with broader objectives of society.'*[59] The latter principle is akin to the preamble of the PRI.[60]

In June 2009, at its first event co-hosted with the OECD, the CDC announced the addition of several new members to the club: China Development Bank, the Russian Development Bank, the Investment Corporation of Dubai, Abu Dhabi-based investment fund Mubadala Development Co., Canadian pension fund OMERS, and Morocco's Caisse de Depot et Gestion (Mullen, 2009).

Study by the Japan Research Institute for Policies on Pension and Ageing

By contrast, a study by the Japanese Research Institute for Policies on Pension and Ageing found that Japanese pension plans have limited adoption of SRI policies and limited knowledge (and adoption) of the PRI. However, the small proportion of Japanese pension funds that have adopted SRI policies *'are highly satisfied with the investment process and investment performance'* (RIPPA, 2008).

Survey of UK asset managers' performance and accountability on ESG issues by FairPensions

The sustainability of institutional investment is not only linked to the decision of trustees, but also to the performance of asset managers. From 2007 to 2008, FairPensions conducted surveys of 30 asset managers in the UK to gauge their level of responsible investment practices. The study defines responsible investment as *'the overarching policy and practices necessary to monitor and manage opportunities and risks arising from "extra-financial" factors including environmental, social and governance (ESG) issues.'*

The study revealed a wide range of levels of responsible investment performance. The results showed an overall increase in the integration of ESG issues since prior surveys. Around 80% of managers interviewed publicly disclosed an ESG policy, although the detail of these policies differed markedly. Furthermore, 22 out of 30 asset managers surveyed reported some public disclosure of voting. By contrast, less than one-third of asset managers disclosed details of engagement of companies over ESG issues. Many asset managers have yet to achieve comprehensive integration of ESG issues: lower performing managers tended to look only at governance, and not at environmental and social factors. Despite the need for improvement in some areas, FairPensions noted that many leading asset managers *'now appear to accept that integrating ESG issues into investment decision making is financially relevant and requires substantial effort and attention to be carried out effectively'* (Fair Pensions, 2008, p 14).

Following on from the 2008 survey, in April 2009, FairPensions published the results of its 2009 survey examining commitment to responsible investment among 30 leading UK pension funds. The results showed an encouraging level of ESG awareness among leading pension funds, while also flagging areas for improvement. All of the schemes surveyed (and for whom relevant data was available) acknowledged the importance of ESG issues in their Statement of Investment Principles (FairPensions, 2009, p 8). Of the pension funds surveyed, six were signatories to the PRI, and these six funds were all among the top ten responsible investment performers (FairPensions, 2009, p 12). Fourteen of the schemes state that they assess responsible investment credentials as part of their asset manager selection criteria (FairPensions, 2009, p 6). Five of the pension funds surveyed screened asset managers for competence in understanding climate change risk and opportunity, and seven required asset managers to consider climate change impact in investment decisions (p 13). The survey also showed that further work was needed in several areas: in particular, stated interest in ESG is not always fully implemented into investment policy and monitoring (p 6), and some pension funds' interest in corporate social responsibility in their investee companies is not adequately matched by a responsible investment commitment within their own organisation (p 9).

Study on long-term and sustainable pension investments by Dr Alex Hesse

Axel Hesse's 2008 study, *Long-Term and Sustainable Pension Investments*, conducted on behalf of ASSET4 and the German Federal Environment Ministry, interviewed ten large European pension funds to discover the extent to which they currently contribute (and have the propensity to contribute) to longer-term, more sustainable investments. Most of the pensions funds interviewed held a strong belief that *'most investors in the financial market act in too short-term a manner'* (Hesse, 2008, p 9). The pension funds interviewed cited a number of reasons for this short term focus, including the dominance of quarterly performance reporting and the fact that asset managers' remuneration is linked to short-term performance (Hesse, 2008). With respect to investment horizons, the average length of investment horizon desired by pension funds was 23 years. However, the pension funds estimated their *actual* average length of investment horizon as six years.

Hesse's study suggests ways to encourage longer-term investment practices. In general, the pension funds interviewed felt that there was a need for higher quality information for company valuation integrating both conventional valuation and sustainability factors. Most of the funds felt strongly that longer-term contracts with *'a basic assumption of continuity, but option of termination'* for external asset managers would help to encourage longer-term investment. Similarly, co-investment by asset managers was seen as a likely to contribute to longer-term investments. Other incentive structures that funds saw as suitable for encouraging longer-term investment included the inclusion of sustainability criteria in the remuneration systems of companies. The funds felt very strongly that cooperation between several pension funds could improve the effectiveness of engagement with companies. Finally, the funds interviewed held a strong belief that pension funds should define clear goals for a long-term investment horizon.

2. How can institutional investors lengthen their investment horizon?

Two publications, both concluded after the publication of the Freshfields Report, provide guidance about the practical steps institutional investors can take toward integrating ESG factors into their investment decisions and developing a longer-term investment horizon.

Guidance note for long-term investing by the Marathon Club

In 2001, the Myners Report highlighted that investors' focus on short-term gain could jeopardise the long-term health of the economy. It called for action by institutional investors themselves to address a number of systemic problems within the institutional investment industry (Myners Report, 2001). Building upon the work of the Myners Report, the Marathon Club has since argued that institutional investors have a key future role in promoting longer-term investment (Marathon Club, 2007).

The Marathon Club, an organisation which promotes long-term thinking and actions by institutional investors, released its *Guidance Note for Long-Term Investing* in 2007. The Club believes that trustees can best create long-term financial benefits for beneficiaries by *'nurtur[ing] genuine economic growth'*. In order to help institutional investors to achieve this goal, the Guidance Note provides *'six key components of a long-term mandate'* (Marathon Club, 2007), as follows:

1. The Marathon Club argues that trustees' commitment to a long-term investment philosophy is essential. As such, trustees investment beliefs should be recorded formally, incorporating

'the trustees' attitude to risk, preferred sources of return, and views on investment styles, governance and ethical issues' (p 3).

2. Trustees should set clear objectives for risk and return.
3. Trustees should choose investment managers carefully, ensuring that their investment techniques fit with the trustees' investment beliefs.
4. The Marathon Club sees the alignment of trustees' goals with those of managers as crucial. As such, the Club *'supports co-investment as probably the clearest and strongest mechanism for gaining alignment of interests'* (p 20). Similarly, the Club advocates the use of performance fees for managers, as long as they are structured carefully to ensure that they promote long-term investment.
5. Trustees should maintain long-term relationships with managers by focusing review meetings on *'testing the continuity of or changes to philosophy, process, systems, people and internal compensation'* (p 3), and managers' personal share holdings rather than on quarterly performance.
6. Finally, the Marathon Club argues that the maintenance of a long-term investment strategy requires strong governance and leadership on behalf of trustees in order to withstand the pressures of an investment environment that generally emphasises the value of short-term gains.

Study on responsible investment approaches of public pension funds by UNEP FI and UKSIF

The 2007 UNEP FI and UKSIF report, *Responsible Investment in Focus: How Leading Public Pension Funds are Meeting the Challenge*, presents 15 case studies to illustrate how public pension funds are taking ESG considerations into account when making investment decisions. In highlighting some of the most effective approaches from around the world, it provides examples of best practice. While each pension fund had its own approach to considering ESG issues, six key themes emerge from the case studies.

1. All the funds interviewed take a systematic approach to the integration of ESG issues into their decision-making, creating guidelines about such issues as when and how to vote proxies, when to engage with businesses, and whether to screen out certain classes of investment.
2. All the funds used respected and transparent standards for evaluating corporate governance and corporate conduct in the companies in which they invest. These standards include, for example, the UN Global Compact Principles, the OECD Principles of Corporate Governance, and the OECD Guidelines for Multinational Enterprises. Similarly, many of the funds employ specialist research firms to obtain ESG ratings for companies.
3. Many of the funds use valuation models for ESG issues that can be used by asset managers as systematic selection tools.
4. Many of the funds seek external advice on issues such as voting and the creation of ESG valuation models, ensuring that they have the best available information and technology to assist their decision-making.
5. Many of the funds offer specialist sustainable funds.
6. Many of the funds interviewed provide funding for organisations that undertake ESG investment research, helping to improve the overall quality of information available to trustees and managers.
7. Finally, many of the funds are signatories to the PRI.

3. ESG integration across asset classes and financial sectors

Private equity

A statement by the Private Equity Council ('PEC') in February 2009 indicates that the scope of interest in responsible investment is expanding to include a broader cross-section of institutional investors. PEC is a Washington-based *'advocacy, communications and research organization and resource center'* for the private equity industry (PEC, 2009). The statement announced that its members have adopted a *'set of comprehensive responsible investment guidelines'* (PEC, 2009) and for which PEC President, Douglas Lowenstein, said:

'Private equity is all about investing for growth and maximizing returns to our investors. To accomplish that today ***requires*** *considering a range of environmental, governance, human capital, and social issues.'*

The guidelines, which grew out of a dialogue between institutional investors and PEC surrounding the PRI, specifically covers environmental, social and governance issues, as well as health, safety and labour issues. The guidelines have nine points (condensed here), targeting both pre-investment and post-investment processes.

Pre-investment, the guidelines call for PEC member firms to *'consider environmental, public health, safety and social issues associated with target companies when evaluating whether to invest in a particular company.'* Post-investment, the guidelines call on firms to continue to consider these issues, as well as to engage with relevant stakeholders, to *'seek to grow and improve the companies in which they invest for long-term sustainability and to benefit multiple stakeholders, including on ESG issues.'* The guidelines seek to ensure that appropriate governance structures are adopted in the area of audit, risk management and potential conflicts of interest, including implementing compensation that aligns the interests of owners and management. They also call upon members to remain committed to compliance with applicable laws in the countries in which they invest, to have strict policies prohibiting bribery, to respect a range of standards relating to labour, and to *'respect the human rights of those affected by their investment activities.'* Finally, the guidelines call for members to provide timely information to their partners about the matters set out in the guidelines, and to encourage their portfolio companies to *'advance these same principles in a way which is consistent with their fiduciary duties.'*

In other jurisdictions, the British Venture Capital and Private Equity Association (BVCA) formed a Responsible Investment Advisory Board in 2009,[61] for which Wol Kolade, Chairman of the BVCA Responsible Investment Board, said:

'Private equity and venture capital firms invest in companies across a range of sectors, employing many thousands of people. As an important part of the economic mainstream it is therefore critical we deepen the engagement of private equity and venture capital companies towards sustainability and responsible investing. We recognise that responsible ownership and business success go hand in hand. This is why we have created a Responsible Investment Board to assist the BVCA in being able to provide practical advice to its members to help them incorporate responsible investment considerations into their business decisions.'

The BVCA also intends to develop guidance on ESG for private equity firms.[62]

Similarly, the Australian Venture Capital and Private Equity Association created a Responsible Investment Sub-Committee in 2009.[63]

Finally, an increasing number of *'general partners and fund of funds…with exclusive or significant activities in the private equity asset class'* (PRI, 2009), now totalling over 30, have become PRI signatories. In mid-2009, the PRI is scheduled to release the publication, *Responsible Investment* *in Private Equity—A Guide for Limited Partners*, to help limited partners apply the PRI in their private equity allocations. It will also implicitly act as a guide to what general partners might wish to consider with respect to responsible investment.[64]

Property

In 2007, UNEP FI established a Property Working Group (PWG) comprising institutional property investors that cooperate to advance responsible property investment thinking and practice globally, including evidence showing how it can protect or enhance financial returns throughout the lifecycle of buildings, while simultaneously reducing negative environmental and social impacts. The group has defined responsible property investment as *'property investment or management strategies that go beyond compliance with minimum legal requirements in order to address environmental, social and governance issues'* (UNEP FI, 2007).

In 2008, in partnership with the PRI, the PWG produced the report, *Building Responsible Property Portfolios—A Review of Current Practice by UNEP FI and PRI Signatories*, articulating how the PRI can be applied to property assets.

Given the tremendous scope of this asset class to combat climate change,[65] the PWG authored the property investment chapter of the UNEP FI Climate Change Working Group publication, *Financing a Global Deal on Climate Change*, a 'green paper' addressing priorities to mobilise the skills and resources of the banking, investment and insurance sectors to achieve an equitable global deal on climate change at the critical UN Climate Change Conference in Copenhagen in December 2009, which will determine the post-Kyoto Protocol regime.

Finally, from 2009 to 2010, in partnership with the Responsible Property Investing Center, the PWG will be releasing a series of toolkits designed to offer practical guidance on embedding responsible property investing in daily institutional practice.

Insurance

Although this report primarily focuses on pension funds, insurance and reinsurance companies (collectively 'insurers') are highlighted in this section for the following reasons:

1. Insurers have immense capacity to manage ESG risks and opportunities given their unique combination of roles as risk managers, risk underwriters and risk carriers on the one hand, and institutional investors on the other.
2. Insurance is one of the largest industries in the global economy. In 2007, world premium volume exceeded USD 4 trillion,[66] while the industry's global assets under management stood at around USD 19.9 trillion.[67]
3. Insurers have 'long-tail' lines of business or long-term liabilities (e.g. liability insurance, life insurance) which mirror the long-term investment horizons of pension funds.
4. ESG issues, such as climate change, are patently financially material to insurers and can impact their insurance and investment portfolios, aside from reputational and liability risks associated with the failure to give appropriate consideration to ESG issues. A UNEP FI study shows one scenario where total costs due to climatic extremes can reach USD 1 trillion in a single year by 2040.[68]

This is in line with the following commentary from Quayle Watchman Consulting cited earlier in this report:

'There is now a very substantial body of evidence and professional opinion in the legal and investment communities that ESG is a mainstream investment consideration and, as such, ESG considerations must be taken into account in investment decision-making. This requires professional investment advisers to do due diligence and inform themselves of ESG considerations

and how they affect different types of investment; for example, the impact of climate change and severe weather on the insurance and reinsurance industry...'

5. Insurers—in their role as institutional investors—are becoming PRI signatories, either as asset owners or through their asset management arms. Some of them are, in fact, founding asset owner signatories.

6. The UNEP FI Insurance Working Group has embarked on an initiative to develop 'Principles for Sustainable Insurance,' focusing on the role of insurers as risk managers, risk underwriters and risk carriers, which is distinct from but complementary to the PRI—a framework that already addresses the institutional investor role of insurers.

This is representative of a growing number of voluntary initiatives that facilitate the integration of ESG issues into investment, financial or business decision-making, supporting Quayle Watchman Consulting's commentary cited earlier in this report:

'There are also a number of important investor and financial codes of practice or statements of principle, such as the Principles of Responsible Investment and the Equator Principles, whereby signatories undertake voluntarily to take into account environmental, social and/or governance (ESG) considerations in making investment and financial decisions. The market impact of voluntary instruments should not be underestimated; in practice, they are ubiquitous and applied widely by their signatories throughout those financial sectors where they have been adopted.'

'It should also be noted, at the very least by way of assuaging the fears of those who foresee a need to build legal bulwarks against litigation for breach of pension fund fiduciary duties, that it is clear that investment, financial and business institutions have adopted a number of voluntary obligations which provide for ESG considerations to figure highly in investment, financial and business decision-making without legal challenge or concerns being voiced over a breach of fiduciary duties. For example, the Principles for Responsible Investment, the Equator Principles and the UN Global Compact Principles have been adopted by over 550 investment institutions, 60 lending institutions and thousands of companies, respectively, without sparking controversy about the fiduciary limits of such institutions and companies.'

In the second quarter of 2009, the UNEP FI Insurance Working Group, comprising many of the world's leading insurance and reinsurance groups,[69] conducted a pioneering global survey on the understanding and integration of ESG factors in insurance underwriting and product development, with the following core objectives:

- Assess the understanding and integration of ESG factors in insurance underwriting and product development globally;
- Assess the financial materiality of ESG factors in insurance underwriting and product development;
- Provide recommendations for sustainable insurance underwriting;
- Provide research input for potential projects on other core insurance processes (e.g. investment, claims management, and sales & marketing);
- Establish a solid business case for the development of 'Principles for Sustainable Insurance.'

The comprehensive survey covered a wide spectrum of ESG factors such as:

- Environmental – climate change, biodiversity loss & ecosystem degradation, water management, pollution
- Social – financial inclusion (microinsurance), human rights, emerging manmade health risks, ageing populations
- Governance – regulations, disclosure, ethics & principles, alignment of interests

The survey obtained more than 250 respondents across the insurance value chain (i.e. insurers, reinsurers, brokers, agencies, insurance supervisors) from over 50 countries worldwide—from Africa and the Asia-Pacific, to Europe, Latin America and the Caribbean, and North America. The summary findings will be published in late 2009.

4. Summary

Responsible investment thinking and practice has come a long way and continues to progress, but there is still a great deal of room for improvement, even more for institutional investors in emerging markets and developing countries where integrating ESG issues into the investment process is relatively in its infancy.

Nevertheless, it is evident from the practical developments and studies featured above that many leading institutional investors are adopting longer-term and more sustainable investment strategies, moving towards greater integration of ESG issues into overall investment philosophy and practice, and across asset classes.

10
AMWG summary conclusion

As members of the UNEP FI Asset Management Working Group, we collectively believe that we owe our clients a duty of care that goes beyond providing robust investment products—important though this is—and extends to include identifying future challenges within the financial system, and doing what is within our power to reduce the chances of further crises.

We believe that the 'Natural Resources Crisis' is one such potential crisis. Consequently, we are integrating ESG issues into our investment analysis and engaging with companies to promote more sustainable business practices in order to avert it.

We believe that through the integration of ESG issues into investment policymaking and decision-making, institutional investors—and the companies that they invest in—will be able to sustain their wealth creation role *and* play their fundamental role in the creation of a more sustainable global economy that invests in real and inclusive long-term growth, genuine prosperity and job creation, in line with UNEP's Green Economy Initiative[70] and the broad objectives of its 'Global Green New Deal':

- Make a major contribution to reviving the world economy, saving and creating jobs, and protecting vulnerable groups;
- Reduce carbon dependency and ecosystem degradation, putting economies on a path to clean and stable development;
- Further sustainable and inclusive growth, achieve the Millennium Development Goals, and end extreme poverty by 2015.

In this context, we summarise our conclusions on the three main elements of Fiduciary II:

Part I
Legal commentary on fiduciary duty and the implementation of ESG in investment mandates

Taking into account the key legal findings and recommendations within Part I, as well as the 2005 Freshfields Report, we are collectively calling for the following actions, as we believe these will magnify the extent to which responsible investment is demanded by the capital markets:

1. Advisors to institutional investors have a duty to proactively raise ESG issues within the advice that they provide, and that a responsible investment option should be the *default* position. Responsible investment, active ownership and the promotion of sustainable business practices should be a routine part of all investment arrangements, rather than the optional add-on which many consultants appear to treat it as.

2. The Principles for Responsible Investment (PRI) should specify that—in order to maintain their membership—all asset manager and asset owner signatories will be required to embed ESG issues in their legal contracts—such as investment management agreements, and Statements of Investment Principles or Investment Policy Statements. The PRI requires that *'where consistent with fiduciary responsibilities'* signatories should commit to integrating ESG issues into investment analysis; to being active, responsible owners by promoting good corporate practice in these areas; and to reporting on what actions they have taken. We believe that embedding ESG issues in their legal contracts will help asset owners hold asset

managers to account for delivering on this important aspect of asset management.

3. Similarly, all consultants, asset managers and other service providers that are signatories to the PRI should make a commitment to proactively raise ESG issues within their advisory and client take-on process.

4. Critically, the PRI monitors the performance of its signatories in delivering the six principles via a relatively detailed questionnaire. This involves an annual assessment that benchmarks each signatory's performance in relation to each principle. This analysis is then shared with signatories, many of whom unfortunately do not share it with their clients, whose assets they manage. While reporting on performance to the PRI is one principle of the PRI, signatories are not required to share these performance assessments with their clients. As asset owners have a fiduciary duty in this area, their agents should be required to make this information available to them at no additional cost. Ultimately, this will lead to more informed market demand for responsible investment.

Part II
Survey of investment management consulting firms on the integration of ESG into the investment process

It is true that there are systemic reasons why fiduciaries have not been demanding sufficient responsible ownership. These problems relate partly to inherent 'free rider' issues. However, Part II has provided us with the following insights:

1. The culture within many consultants and asset managers can be to neglect these issues and to treat them with a 'tick box' mentality, rather than an issue of substance which needs to be measured and appraised. This culture should also be recognised and addressed by policymakers and civil society.

2. The most important aspect of the PRI is arguably that institutional investors, collectively representing approximately USD 18 trillion in assets under management to date, have endorsed Principle 4, which states that:

   'We will promote acceptance and implementation of the Principles within the investment industry', including possible concrete actions such as but not limited to following:

   - *'Include Principles-related requirements [ESG integration and engagement requirements] in requests for proposals (RFPs);* and
   - *'Align investment mandates, monitoring procedures, performance indicators and incentive structures accordingly (for example, ensure investment management processes reflect long-term horizons when appropriate).'*

   It is our experience, however, that very few asset owner signatories to the PRI are in fact adopting this approach—and those asset owner signatories that have adopted this approach have helped generate a notable increase in the overall levels of ESG integration and engagement among asset managers. We believe that there is still some way to go on the commitment of PRI signatories to implement Principle 4, and that the key legal findings and recommendations within Part I of this report should be embedded within the PRI itself to accelerate progress.

Part III
Practical developments on the integration of ESG into the investment process

Despite the cultural problems mentioned above, Part III, together with our views on Parts I and II, brings us to our concluding views on fiduciaries, policymakers and civil society:

1. Fiduciaries have a duty to consider more actively the adoption of responsible investment strategies.
2. Fiduciaries must recognise that integrating ESG issues into investment and ownership processes is part of responsible investment, and is necessary to managing risk and evaluating opportunities for long-term investment.
3. Fiduciaries will increasingly come to understand the materiality of ESG issues and the systemic risk they pose, and the profound long-term costs of unsustainable development and the consequent impacts on the long-term value of their investment portfolios.
4. Fiduciaries will increasingly apply pressure to their asset managers to develop robust investment strategies that integrate ESG issues into financial analysis, and to engage with companies in order to encourage more responsible and sustainable business practices.
5. Global capital market policymakers should also make it clear that advisors to institutional investors have a duty to proactively raise ESG issues within the advice that they provide, and that a responsible investment option should be the *default* position. Furthermore, policymakers should ensure prudential regulatory frameworks that enable greater transparency and disclosure from institutional investors and their agents on the integration of ESG issues into their investment process, as well as from companies on their performance on ESG issues.
6. Finally, civil society institutions should collectively bolster their understanding of capital markets such that they can play a full role in ensuring that capital markets are sustainable and delivering responsible ownership.

The key question is whether these current trends among fiduciaries, along with commensurate actions from policymakers and civil society institutions, will reach a tipping point where the asset management industry is sufficiently engaged to help avert the Natural Resources Crisis.

Some have argued that the ongoing financial crisis may not have been so deep or so protracted if institutional investors had been collectively willing to challenge the financial institutions that were at the heart of creating the systemic risks within the financial system. We also believe that one of the most important lessons from the crisis is that institutional investors' responsible ownership needs to be strengthened in order to be fit for purpose.

Overall conclusion

We believe that the global economy has now reached the point where ESG issues are a critical consideration for *all* institutional investors and their agents.

In the words of United Nations Secretary-General Ban Ki-moon (May 2009):

'It is time to create market incentives that reward long-term investment…'

We believe that implementing the findings and recommendations of Fiduciary II will move us towards this goal, and help create responsible and sustainable capital markets that would accelerate the transformational process to a green, inclusive and sustainable global economy.

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Appendix A

Legal developments on fiduciary duties and ESG issues

1. Fiduciary duty, ESG issues and the law - The Freshfields Report

In 2005, the UNEP FI Asset Management Working Group (AMWG) commissioned Freshfields Bruckhaus Deringer to write a report ('the Freshfields Report'[71]) clarifying the legal limits of institutional investors' discretion to consider ESG issues in investment decisions.

Freshfields examined this issue across both common law and civil law jurisdictions, particularly in Australia, Canada, France, Germany, Italy, Japan, Spain, the United Kingdom, and the United States. The Freshfields Report set out not only to identify the legal rules regarding institutional investors' ESG consideration in these jurisdictions, but also to clarify misconceptions about these rules.

The Freshfields Report found that, within the bounds of specific restrictions inherent in individual fund agreements, institutional investors do have some discretion to consider ESG issues when making investment decisions. The limits to this discretion differ according to jurisdiction.

2. Legal limits to the discretion to consider ESG issues at common law

At common law, institutional investors are bound by relevant legislation, fiduciary duties, the general law of negligence, and contracts. Of these sources, the Freshfields Report found fiduciary duties constitute the main limit upon investors' discretion.

In general terms, fiduciary duty is a high level of duty, *'something stricter than the morals of the market place*[72]*',* that arises out of a relationship of trust in which the trustee has power to exercise discretion in the interests of the beneficiary. In the institutional investment context, trustees of funds owe fiduciary duties to beneficiaries to exercise reasonable care, skill and caution in pursuing an overall investment strategy suitable to the purpose of the trust (in the US) and to act prudently and for a proper purpose (in the UK). The trust deed and rules outline the purpose for the trust, so that while most institutional investment funds aim to create financial benefits for the beneficiaries, it is also possible for trust deeds explicitly to require trustees to consider ESG factors in investments.

Where their discretion to consider ESG issues is not made explicit in the trust deed, institutional investors in the common law world have often argued that their fiduciary duties require them to focus solely on maximising profit for the beneficiaries, and prevent them from considering ESG factors in their decision-making (Richardson, 2008; UNEP FI, 2005). The Freshfields Report argued that institutional investors' reluctance to consider ESG impacts is misplaced.

The United Kingdom

The most often cited UK case law regarding the scope of pension fund trustees to incorporate ethical concerns is *Cowan v. Scargill* (1984).[73] The question under consideration by the judge, Megarry VC, was whether it was legitimate for trustees to restrict funds to investments in the UK and prohibit investments in industries competing with the coal industry. In what has come to be referred to as 'The Megarry Judgement', Megarry VC made the following observations:

- A trustee must take *'such care as an ordinary prudent man would take if he were minded* *to make an investment for the benefit of other people for whom he felt morally bound to provide.'*

- It was the main duty of trustees *'to exercise their powers in the best interests of the present and future beneficiaries.'*
- If the trust provided financial benefits, then *'the best interests of the beneficiaries are normally their best financial interests.'*
- '*Although a trustee who takes advice on investments is not bound to accept and act upon that advice, he is not entitled to reject it merely because he sincerely disagrees with it, unless in addition to being sincere he is acting as an ordinary prudent man would act.'*
- *'In considering what investment to make, the trustees must put on one side their own personal interests and views.'*
- *'In the case of a power of investment, as in the present case, 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...'*[74]

(Cowan v. Scargill [1985] Ch 270)

This putting to one side of personal interests and views has been interpreted as constraining the extent to which trustees can prohibit certain companies from investment on the basis of ethical concerns. However, Megarry VC subsequently clarified the scope of his judgement and suggested that it is being misinterpreted. In one of the most detailed reviews of UK case law as it applies to the integration of ESG issues into investment, Scanlan et al (2005) argue that this case is misapplied to modern sustainable and responsible investment that integrates ESG considerations and state that:

'...the main aim of the policy which was disallowed in Cowan vs Scargill, to protect the UK coal industry, bore little or no resemblance to the kind of objectives which are likely to inform a modern SRI policy... The case did not touch on the question of whether taking [ESG] considerations into account in the selection, retention and realisation of investments can contribute to investment returns. Similarly, the case was not concerned with whether trustees should engage in shareholder activism [see 'Engagement' in Appendix B]*, in relation to either corporate governance issues or corporate social responsibility issues in particular, in order to preserve or increase the value of trust investments.'*

Similarly, the Freshfields Report argued that while the Megarry Judgement confirms that fiduciary powers must be exercised *'carefully and fairly for the purposes for which they are given and not so as to accomplish any ulterior purpose',* it does not limit fiduciaries to considering only financial factors when making investment decisions.[75]

Instead, the Freshfields Report argued that the Megarry Judgement suggests that *'pension fund trustees will fulfil their fiduciary duties provided they treat the purpose of the investment power [ordinarily the creation of financial benefit] 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'* (UNEP FI, 2005, p 89).

The Freshfields Report also found that the safest way for UK beneficiaries to ensure that institutional investors consider ESG issues is to make their discretion to do so explicit in the trust deed and rules: *'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'* (UNEP FI, 2005, p 87). The report equally highlighted that as ESG issues are frequently material to investment decision-making—both in the short and long term—integrating such issues within the investment process is entirely consistent with a trustee's fiduciary duty. In other words, so long as the issues in question are relevant to the long-term cash flows of the business, then it is entirely appropriate to factor them into investment decision-making.

In addition to acting in accordance with their fiduciary duty, institutional investors in the UK must meet all relevant legislative requirements, including those in the Pensions Act (1995) and the Pensions Act (2004). They must also comply with the general law of negligence and contract law.

The United States

Both federal and state legislation and common law rules regulate institutional investment in the US. It is not necessary to reflect on the full breadth of US jurisprudence on investors' duties here. However, it can be said that most of these sources of law require institutional investors to follow the 'modern prudent investor rule'. This rule, incorporating the traditional fiduciary duties of prudence and loyalty, requires prudent investment across a whole portfolio in the best interests of the beneficiaries and for the purposes of the fund.[76]

As in the UK, the main perceived restriction on institutional investors' discretion to consider ESG factors in investment decisions comes from fiduciary duties, in this case as contained in the modern prudent investor rule. In particular, a number of commentators have argued that the duty of loyalty expressed in the rule proscribes institutional investors from considering ESG factors in investment decisions.[77] However, the US Department of Labor has taken the view that fiduciary duties:

'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 is expected to provide an investment return commensurate to alternative investments having similar risk.' [78]

The Freshfields Report concluded that, in the US, *'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'* (UNEP FI, 2005, p 109). Indeed, the Freshfields Report noted that the duty of prudence may even require investors to consider relevant ESG factors when making investment decisions (UNEP FI, 2005, p 114).

3. Legal limits to the discretion to consider ESG issues at civil law

Fiduciary duty, as a creature of the common law, does not apply in civil law countries. Instead, civil law regimes protect investment fund beneficiaries through legislation that contains a range of duties for institutional investors. Across all civil law jurisdictions examined, the Freshfields Report found that several duties remain constant. These are:

- a duty to act 'diligently' (Spain), 'professionally' (Italy) or 'prudently' (France) in the interests of beneficiaries;
- a duty to seek profitability (except in Japan; and in Germany the profit must be 'sustainable');
- a requirement to ensure adequate portfolio diversification (either implicitly or explicitly in keeping with the modern portfolio rule); and
- varying duties relating to liquidity and allowable asset types for certain funds.

The Freshfields Report concluded that institutional investors in civil law countries have varying levels of discretion to consider ESG factors depending on the statute that applies in their particular jurisdiction.

4. Summary of the Freshfield Report's conclusions

The Freshfields Report points to ESG reporting obligations in many jurisdictions as evidence that the consideration of ESG issues is becoming increasingly important.[79] It found that as institutional investors in all jurisdictions examined have a duty to create financial benefit for the beneficiaries of their funds, ESG considerations are not only legally permissible but also potentially required to the extent that ESG factors will have a material impact on the financial performance of potential investments. The consideration of ESG issues may also be required in cases where the beneficiaries of certain funds mandate an investment strategy with criteria that go beyond financial performance (UNEP FI, 2005, p 13).

5. Recent developments in law and commentary on fiduciary duty and ESG issues

Despite the Freshfields Report's work in the area, some institutional investors still appear to be uncertain about the breadth of their discretion to consider ESG issues. In a 2008 study, Axel Hesse examined ten European pension funds' views of fiduciary duty and sustainability. The pension funds interviewed felt strongly that *'clarification by the legislator whether sustainability can be taken into consideration by the pension fund is desirable for the legal certainty with regard to fiduciary duty'*[80] (Hesse, 2008, p 43). As a result, argued Hesse, all countries should clarify the relationship between fiduciary duty and ESG considerations.

While no significant legal case has been heard since the publication of the Freshfields Report, two legal developments have occurred, which could affect institutional investors' discretion to consider ESG issues in investment decisions. The first is a UK parliamentary comment on ESG consideration by institutional investors. The second is the US Department of Labor's release of two interpretive bulletins affecting economically targeted investments and shareholder rights.

UK House of Lords comment on fiduciary duty and ESG issues

The UK Companies Act 2006 made significant progress towards the recognition of the role of corporations and investors in fostering sustainability (see Clark and Knight, 2009). While the Companies Act 2006 does not include legislation with respect to institutional investors' discretion to have regard to ESG issues, by requiring company directors to consider *'the impact of the company's operations on the community and the environment'*, the Act underlines the UK government's growing appreciation of the importance of ESG factors in business. Furthermore, the government has reserved powers under the Act to require institutional investors to disclose their share voting in the future (Watson Wyatt, 2008).

On 7 October 2008, the UK House of Lords shed further light on the consideration of ESG issues in investment decisions. In speaking about a proposed amendment to the Pension Bill, Lord McKenzie stated that *'there is no reason in law why trustees cannot consider social and moral criteria in addition to their usual criteria of financial returns, security and diversification'* (Wheelan, 2008b). Lord McKenzie went on to say that:

'It follows from this that it may be appropriate for trustees to engage in these considerations with companies in which they invest. This may include disinvesting from such companies if, acting in accordance with their fiduciary duties and the objects of their trust, they consider that this is right and in the best interests of their members.' (Wheelan, 2008b)

Lord McKenzie's comments reinforce the argument of the Freshfields Report that trustees are not precluded from having regard to ESG issues in making investment decisions.

US Department of Labor interpretive bulletins regarding institutional investors

On 17 October 2008, the Employee Benefits Security Administration, an agency within the US Department of Labor, released two interpretive bulletins dealing with the subject of ESG considerations in institutional investment.

The first bulletin provides *'supplemental guidance relating to fiduciary responsibility in considering economically targeted investments'*[81] ('the ETI bulletin'). The second bulletin provides clarification on *'the exercise of shareholder rights and written statements of investment policy, including proxy voting policies or guidelines'*[82] ('the shareholder rights bulletin'). The bulletins are intended to reiterate and clarify the Department of Labor's *'longstanding view that workers' money must be invested and used solely to provide for retirements and not for political, corporate or other purposes'* (Department of Labor news release, 16 October 2008).

The ETI bulletin states that Employee Retirement and Income Security Act (1974) ('ERISA') *'establishes a clear rule that in the course of discharging their duties, fiduciaries may never subordinate the economic interests of the plan to unrelated objectives, and may not select investment on the basis of any factor outside the economic interest of the plan'*. However, where two or more alternative investments *'are of equal economic value'*, fiduciaries are permitted to *'choose between the investment alternatives on the basis of a factor other than the economic interest of the plan'*. The bulletin highlights the Department of Labor's belief that fiduciaries who rely on non-economic factors to make investment decisions will find it difficult to prove compliance with ERISA *'absent a written record demonstrating that a contemporaneous economic analysis showed the investment alternatives were of equal value'*.

The shareholder rights bulletin states that the fiduciary duties described in ERISA *'require that, in voting proxies, regardless of whether the vote is made pursuant to a statement of investment policy, the responsible fiduciary shall consider only those factors that relate to the economic value of the plan's investment and shall not subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives'*.

The shareholder rights bulletin also reinforces that all proxy voting guidelines in statements of investment policy must comply with fiduciary duty. As such, these *'may not subordinate the economic interests of the plan participants to unrelated objectives'*.

While Department of Labor bulletins are only binding upon institutional investment funds that are governed by ERISA and do not affect general trust law, they are nonetheless likely to influence judicial interpretation (Kinder, 2008). These bulletins are not intended to change, but rather to reiterate and clarify, the obligations of institutional investors in choosing investments.

The bulletins have received some criticism from ESG experts. Shortly after the publication of the bulletins, the Social Investment Forum ('SIF'), wrote an open letter to the Department criticising several inconsistencies and ambiguities in the bulletins' language (SIF, 2008). The SIF letter argues that internal inconsistencies and ambiguous language in the bulletins could discourage prudent decision-making by trustees in the area of investment policies, proxy voting and shareholder engagement with companies.

The SIF letter calls for new guidance to clarify these issues and to reiterate the Department of Labor's explicit position that ESG considerations are consistent with fiduciary duties and can be justified—like any other factors that fiduciaries take into account—on an economic basis as likely to advance the financial performance of a plan's portfolio.

There is also no indication that the guidance is meant to contradict the Department of Labor's long-held position that the interests of the beneficiaries cannot be subsumed to other interests. See, for example, the letter from the Department of Labor to William M. Tartikoff, Senior Vice President and General Counsel of Calvert Group Ltd. (28 May 1998) (the 'Calvert Letter'). Nor does it appear to change the basic premises of fiduciary law—the duties of loyalty and prudence. See, *Withers v. Teachers' Retirement System.*[83] Under this standard, fiduciaries of pension systems have an obligation to current and future retirees. This obligation, inherently calls for a long-term perspective that would support the inclusion of systemic issues, such as ESG issues like climate change, into investment management decisions.

Finally, President Barack Obama recently nominated Phyllis C. Borzi to be Assistant Secretary of Labor for Employee Benefits Security at the Department of Labor. In this position, Ms. Borzi will have the opportunity to revisit these bulletins. Given her long history as an expert on pension and ERISA issues and the strong support she has from organised labour, there is an expectation that new guidance will be forthcoming.

The US Congress and the Sudan Accountability and Divestment Act – The financial materiality of social issues to investment

In December 2007, the US Congress unanimously passed and the US president signed the Sudan Accountability and Divestment Act (SADA) into law, which gives states and local governments the express right to divest interests in Sudan. Section 3 of SADA states that:

'It is the sense of Congress that the United States Government should support the decision of any State or local government to divest from, or to prohibit the investment of assets of the State or local government in, a person that the State or local government determines poses a financial or reputational risk.'

SADA therefore may have significant consequences for companies whose ESG activities pose a financial or reputational risk to investors. As such, SADA has contributed to the body of law which may make social issues increasingly relevant considerations for trustees.

Academic commentary since the Freshfields Report

Since the publication of the Freshfields Report, a number of academic articles have dealt with the subject of fiduciary duty and ESG issues. Sethi (2005), writing as the Freshfield Report was nearing completion, argues that responsible investing is 'not merely discretionary and desirable' but 'a necessary imperative'. Benjamin Richardson, a professor of environmental law at York University has written a number of articles and a book on socially responsible investment law. Richardson notes that a number of factors affect the relationship between fiduciary duty and ESG considerations. First, while trustees must create benefit for beneficiaries, Richardson asserts that 'conceptually, a "benefit" to beneficiaries need not be limited to a financial benefit' (Richardson, 2008, p 269). Second, Richardson points out that 'SRI has become increasingly less controversial to the market precisely because it hardly challenges the economic values that underpin fiduciary norms' (Richardson, 2008, p 271). In other words, the consideration of ESG issues is often aligned with prudent financial assessment. However, Richardson notes that the correlation between environmental performance and financial performance is affected by the content and strength of environmental regulation (Richardson, 2007, p 162).

3. Conclusions

While the debate about the relationship between fiduciary duty and ESG considerations cannot be concluded in the absence of specific legislation or legal decisions, the findings of the Freshfields Report, which broadly support institutional investors' consideration ESG issues in making investment decisions in the best interests of beneficiaries, appear to have been bolstered by subsequent developments in commentary.

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Appendix B

The four main sustainable and responsible investment (SRI) strategies [84]

This appendix is an excerpt from *Trustee Tutor Training Guide — An introduction to sustainable and responsible investment for institutional trustees*, Aviva Investors.

Some in the sustainable and responsible investment (SRI) industry can point to over ten different SRI strategies, but we believe that they can essentially be boiled down to four. However, it is important to highlight at the outset of this section that while these four strategies can be used uniquely as alternatives, they can also be combined to develop increasingly sophisticated SRI strategies that are tailored to individual client investment requirements (see Section 5 below – 'Combining strategies').

These four main SRI strategies are reviewed below:

1. Integration

Mercer Investment Consulting defines integration as '*the active investment management processes that include an analysis of environmental, social and corporate governance risks and opportunities*' (Mercer Investment Consulting, 2007). It should be applied across the full pension scheme and involves adapting a more conventional investment process to explicitly integrate an analysis of how ESG issues impact corporate earnings and affect valuations. The purpose is principally to achieve better overall investment decision-making and enhance risk-adjusted outperformance. It is based on the premise that there is market inefficiency in this area and that investors can underestimate the value of sustainable and responsible businesses.

Investment implications

If there is market inefficiency surrounding ESG issues, and the issues are relevant to the company concerned, then *integration* should reduce risk and enhance returns. See also Section 2 above, which includes a number of relevant references.

Sustainability implications

Integration analysis may conclude that unsustainable and/or irresponsible behaviour is not material to investors' time horizon and is therefore not an issue for investors. However, if there is financial market inefficiency in analysing ESG issues—and good corporate practices would be rewarded—then integration has considerable potential to promote responsible long-term business behaviour. Where a market *failure* exists—and unsustainable business practices are rewarded by the market—some leading fund managers are beginning to engage with government policy makers to promote appropriate government responses that avert the worst economic impacts of the issue (see Hawley and Williams for more on what has come to be called the 'Universal Owner Hypothesis').

The top ten questions on integration for Trustees to consider:

1. How does the fund manager integrate ESG analysis into stock selection?
2. Are you convinced that the fund manager's approach to integration is genuinely applied? Can they provide you with a number of credible examples of this analysis?
3. Do they have sufficient dedicated resources, experience and expertise?
4. Does the fund manager's SRI portfolio outperform more conventional approaches to investment over different time periods?
5. What are the risk characteristics of their process?
6. Do they direct research commission towards high quality broker research on ESG issues?
7. Can they demonstrate that they provide broker feedback on this research?
8. What atypical sources of investment information do they use—i.e. where do they source their ESG research from?
9. How is engagement incorporated into the investment process? Will an intransigent company be divested?
10. Will the fund manager engage with government policy makers to help correct a market failure?

2. Engagement

Some fund managers engage with companies in order to encourage more responsible business practices and to increase corporate accountability to shareholders in companies they own or seek to own. If this strategy is chosen it should also be applied across the full pension scheme. Engagement mainly takes the form of dialogue between investors and companies on issues of concern, and should include the proxy voting practices at company annual general meetings (AGMs). The aim is generally to work with the company to improve corporate performance on ESG issues and to enhance long term returns to shareholders. It can also be known as *shareholder activism*, although some use this term for a style of company engagement that is much more adversarial.

Investment implications

A dialogue between major investors and companies on issues of concern should reduce risks, and support long-term wealth creation. As an engagement strategy can overlay an otherwise conventional portfolio, it does not necessarily change stock picking, and may therefore not have any positive or negative implications at all for investment returns. However, we believe that engagement is best conducted in the context of an actively managed portfolio, where the results can be integrated into the investment analysis.

Chapter 5 of the Myners Principles covers the role and functions of fund managers (HM Treasury, 2004). The section on shareholder activism is the most significant for SRI concerns. It reviews numerous arguments on the subject of shareholder activism, discusses legal policy concerning fund managers and the requirements of their clients and makes recommendations. In response, the Institutional Shareholder Committee has drawn up a document entitled *'The responsibilities of institutional shareholders and agents: Statement of Principles'* (2005). This '*sets out best practices for institutional shareholders and/ or agents in relation to their responsibilities in respect of investee companies.*' These concern the way institutional investors and their agents discharge their responsibilities, monitor performance, make necessary interventions and evaluate and report on the effectiveness of their engagement, and are increasingly included within investment management agreements (IMAs).

Sustainability implications

Some believe that engagement can be used as an excuse for holding a company with poor ESG performance. There may be some justification in this view as there do appear to be occasions where some fund managers have used engagement in this way. However, at its best we believe that engagement is a credible and effective SRI strategy for generating corporate improvements on a range of ESG issues. As owners of the company, investor views are influential. In our experience, supporting good ESG practices and challenging poor performance at company-investor meetings can motivate significant corporate improvement across a range of issues. This is particularly the case when engagement is integrated into both the investment decisions as well as the proxy voting actions at company annual general meetings (AGMs).

There are a few fund managers that provide *unbundled engagement* or *engagement overlay* products. This means separating, or unbundling, the fund management and voting/engagement arrangements between two or more parties. There are circumstances where it may be appropriate to adopt this strategy. For example, if the Trustees believe that the existing fund manager will continue to deliver investment outperformance but is incapable or unwilling to provide the resources to voting and effective engagement. However, we believe that it is far better to integrate the results of engagement into an actively managed portfolio and for any engagement to be conducted by the fund managers and analysts who are also responsible for making the investment recommendations. This ensures that the engagement recommendations are genuinely in the long-term interests of the creation of shareholder value. It also ensures that any financial value to the client's portfolio from the engagement discussions become directly embedded within the portfolio's investment process. Longer term, unbundled or overlaid engagement products have the potential to create unhealthy competition in an area where investors have a shared interest and should collaborate.

The top ten questions on engagement for Trustees to consider:

1. How is investment incorporated into the engagement process—i.e. how do the results of engagement get reflected in the investment decisions?
2. Do they have sufficient dedicated resources, experience and expertise?
3. What are the aims of the engagement process—just to improve long-term shareholder returns, just to improve corporate responsibility—or both?
4. Does the fund manager actively support good corporate practices as well as challenging poor performance?
5. Is there an approach to managing the engagement that targets specific companies on particular issues?
6. Do they measure their effectiveness? If so, how effective are they?
7. Is there evidence that the fund manager's engagement has helped improve shareholder value?
8. Does the fund manager actively use the AGM proxy voting process? If so, does the vote apply to all funds under management or just those in the specific client's portfolio?
9. What oversight of the engagement process is there?
10. Is the fund manager an active member of the UN PRI? If so, are they prepared to share their annual performance assessment—and—can they demonstrate active use of the *PRI Engagement Clearinghouse* in order to collaborate with other institutional investors?

3. Preference or positive screening

This approach seeks to invest in those companies with a commitment to responsible business practices, positive products and/or services and can come in a number of forms. These include best of sector, or sustainability thematic investment, such as investing in environmental technologies, or use the impacts of climate change as a way of highlighting investment opportunities.

Investment implications

Some forms can lead to a bias towards smaller companies with implications for the volatility of the fund's performance against its benchmark. However, as mentioned above, when done well there is good evidence that ESG thematic analysis can lead to performance improvement.

Sustainability implications

Positive screening can lead to a reduction in cost of capital for more sustainable businesses and help them raise capital—particularly for the smaller cap companies. Some see this as priming the pumps of sustainable development and one of the most important contributions that an investor can make towards creating a more sustainable future. However, if the investor wants to support micro-cap social enterprises listing on the Alternative Investment Market (AIM), then they should ensure that they are within scope as the risk parameters will often lead to them being excluded.

The top ten questions on positive screening for Trustees to consider:

1. Should the full scheme use positive ESG screens or themes? If so, which ones?
2. Do the Trustees believe that allocating part of the portfolio towards specific ESG themes would be a useful way of adding diversification strategy?
3. Do the schemes defined contribution beneficiaries want to be able to choose positively screened SRI funds?
4. Does the fund manager's SRI portfolio outperform more conventional approaches to investment over different time periods?
5. Is it better to specify investments in single-themed funds (for example, climate change, water etc.), or allow the fund managers to select between the relative benefits of a range of different themes based on prevailing market conditions?
6. Is a bias towards smaller companies inherent within the approach of the fund manager? If so, what are the implications for the volatility of the fund's performance against its benchmark?
7. What is the volatility tolerance within the fund and can derivatives be used to manage risk?
8. What is the process for ensuring that the portfolio adheres to the fund remit?
9. Does the portfolio breakdown appear to be consistent with the stated funds aims?
10. Do the Trustees want to ensure that they include social enterprises? If so, what should be the minimum market value of these companies and how much of the portfolio should they represent?

4. Avoidance or negative screening

Description

This is the most commonly recognised form of SRI. It means not investing in companies that do not meet the ethical standards by which the fund is run. This is often also referred to by the term '*ethical investment*' and essentially means avoiding companies that provide products or services that are ethically (if not legally) questionable. Most ethical funds, for example, will not invest in tobacco or defence companies.

This strategy initially evolved for certain church and charity groups which wanted to ensure that they were not benefiting financially from investments in companies that were inconsistent with their beliefs or aims.

Investment implications

When used as the only SRI strategy, such funds are more likely to underperform the overall market while excluded areas are performing well. Conventional wisdom suggests that arbitrarily excluding a sector will decrease the return/risk ratio for a fund. Proponents would counter that many ethical exclusions do have investment relevance making the impact less pronounced. There is some research into the long-term impact on retail ethical funds that suggests that risk-adjusted returns can be at least as good. The key here is fund manager selection.

Sustainability implications

This strategy ensures that individual investors are not benefiting financially from investing in certain areas, which can be centrally important to institutions seeking to ensure that their organisational ethics or brand integrity are maintained. However, it is unlikely to decrease a company's access to capital as the volume of assets currently affected is swamped by ethically unconstrained assets. Separately, negative screening removes the potential for ownership engagement (see below). However, if a company can change to become approved for the fund, then it may. Finally, some question whether simply avoiding certain types of company actually results in a portfolio that can be described as ethical.

The top ten questions on negative screening for Trustees to consider:

1. Are ethical screens consistent with the aims of the full scheme and the fiduciary duties of the Trustees? If so, which ethical screens should be implemented and how will they be applied?
2. Should defined contribution beneficiaries be allowed access to negatively screened SRI options within the scheme?
3. Does the fund manager's negatively screened SRI portfolio outperform more conventional approaches to investment over different time periods?
4. Is a bias towards smaller companies inherent within the approach of the fund manager? If so, what are the implications for the volatility of the fund's performance against its benchmark?
5. What is the volatility tolerance within the fund and can derivatives be used to manage risk?
6. What is the process for ensuring that the portfolio adheres to the fund remit? Is there any independent oversight of the process, perhaps from the internal audit function or from an external advisory committee?

7. Are the Trustees assured that the Asset Manager can implement the screening?
8. Does the portfolio breakdown appear to be consistent with the stated funds aims?
9. Will the Trustees require a periodic portfolio screening report to ensure that the screens are being applied?
10. Should the Trustees combine this strategy with other strategies such as positive screening and engagement?

5. Combining strategies

The previous section highlighted that while the above four strategies can be used independently as alternatives, they can also be combined in order to develop increasingly sophisticated SRI strategies tailored to individual client investment requirements.

For example, for defined benefit pension schemes, a combined institution-wide approach might *integrate* an analysis of material ESG issues into the overall investment process, *avoid* some sectors on ethical grounds and/or because they are poor long-term investments and not worthy of consideration, *positively screen* a percentage of the portfolio towards companies providing sustainable goods and services on the basis that they will benefit from the long term secular trends towards more sustainable goods and services, and *engage* with the companies that they do own in order to support good ESG practices and challenge poor performance.

In addition, for defined contribution pension schemes, depending on interest, there may be scope to offer a range of *negatively screened* ethical options which beneficiaries can opt into.

However, it should be noted some contradictions do emerge when combining strategies. Most obviously, screening out a company from a portfolio would mean the loss of the ability to engage with it as an owner. The key is in understanding these implications and selecting the approach that the Trustees consider best fits the investment strategy of the scheme.

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Appendix C

UNEP FI Asset Management Working Group survey questionnaire for investment management consulting firms and good practice responses from Mercer Investment Consulting Inc. and Watson Wyatt Worldwide

With their permission, the AMWG is featuring the full responses of Mercer Investment Consulting Inc. ('Mercer') and Watson Wyatt Worldwide ('Watson Wyatt') which, in the AMWG's opinion, generally represent good practice among all consultants surveyed.

For the sake of completeness and comparability, and in order to facilitate analysis and synthesis, we request that you kindly respond in the following format:

On fiduciary duty

Q1 Does your firm have a unit or consultant staff dedicated to working with clients who request ESG integration, have an SRI mandate, or have investment policy guidelines concerning, for example, climate change? If not, how are you prepared to respond to clients with such requests?

Mercer:
Yes. Mercer formally established its Responsible Investment team in 2004. We are 18 full-time staff around the world.

Watson Wyatt:
Watson Wyatt's Sustainable Investment ASK (area of special knowledge) comprises two full-time and five part-time staff who focus on:

- investigating specific investment opportunities arising from the sustainability arena
- assessing how managers integrate ESG considerations into their mainstream investment processes
- providing client advice on a wide range of sustainable investment matters

The global manager research team comprises over 71 full-time and 72 part-time researchers (as at 31 May 2009) that increasingly take ESG factors into account in manager research more generally.

Watson Wyatt's Thinking Ahead Group (TAG) conducts thought leading research focusing on long term trends shaping the investment and pensions landscape. TAG and the Sustainable Investment ASK work closely on a number of areas such as the investment implications of sustainability issues including climate change.

Q2 Have you observed an increase in client interest on ESG matters when selecting investment managers?

Mercer:
Yes.

Watson Wyatt:
We advise more than 1,000 pension funds and institutional investors with assets of approximately USD 2 trillion. Our clients include six of the largest U.S. pension funds and over 30 percent of FTSE 100 companies.

Over recent years, we have noted an increase in awareness and interest in sustainability issues amongst our clients. This manifests itself in a number of ways, one of which is a desire by them to understand more about how managers address ESG issues within their mainstream investment process.

Q3 Do you consider that integration of ESG matters is a requisite aspect of investment management? Please explain why.

Mercer:
Yes. We believe that ESG factors can have a material impact on corporate financial performance and therefore on portfolio performance, though materiality may vary by sector and geography and ESG may manifest itself in different ways depending on investment strategy, asset class and the skill of the investment manager.

Watson Wyatt:
The impact of ESG issues on investment returns is difficult to isolate and varies across different asset classes, investment strategies, financial instruments, investment time horizons, industry sectors and geographical regions. For these reasons we do not believe the integration of ESG factors is necessarily a requisite aspect of investment management in all cases. The consideration of ESG factors on investment returns is arguably more important in some investment strategies, such as long-term long-only equity. Where ESG issues have relevance for investment returns we encourage investment managers to give these due consideration within the investment decision making process.

Q4 Do you consider that integration of ESG matters is a requisite aspect of investment management as part of fiduciary duty? Please explain why.

Mercer:
Yes. An increasing body of evidence exists to show that ESG factors can impact investment performance. Therefore, fiduciaries concerned with long-term preservation and growth of capital should have some understanding of how ESG factors may affect their portfolios.

Watson Wyatt:
Where ESG factors have the potential to materially impact investment returns we would expect investment managers to be mindful of these issues when making investment decisions as part of their fiduciary duty. We would also expect investment managers to integrate ESG considerations where the client has explicitly required them to so and is practically possible.

Q5 When considering the interests of the ultimate owners of capital (beneficiaries, insured individuals, mutual fund investors, and so forth), do the interests that ought to be considered by fiduciaries go or do not go beyond purely financial interests? In other words, under what circumstances do you see ESG factors requiring consideration in investment management? Please explain.

Mercer:
As above, we believe ESG factors fall within the purview of fiduciary duty where they are or may be material to long term capital preservation. ESG factors may also contribute to the growth of investments as related opportunities are sought. So while ESG issues may be considered

beyond financial interests, they are most relevant to investors where there is a financial link. How social or political issues may be reflected in investments or what role participants may play in developing a social investment mandate is for each organization to decide.

Watson Wyatt:
Where our clients explicitly express 'non-financial' objectives within their investment objectives we seek to accommodate these as far as is practically possible. Where clients have not expressed such objectives we would not impose any restrictions or ESG requirements on managers. However, where ESG factors have the potential to materially impact investment returns we would expect investment managers to be mindful of these issues when making investment decisions as part of their fiduciary duty.

Q6 In your view, where does the responsibility for the exercise of ESG integration reside? How does it distribute as between trustees, pension fund managers, investment managers, and consultants? What is the role of each?

Mercer:
In order for ESG issues to be well integrated into a pension plan or retirement system all of the above parties must have some understanding of the issues. Ultimately the responsibility rests with Trustees, pension managers and to some extent, beneficiaries. However, these parties cannot act on this without some assistance, leadership and guidance from investment managers, consultants and others.

Watson Wyatt:
By definition the integration of ESG factors within investment management is exercised by those directly responsible for managing investments—internal and/or third party managers. However, other stakeholders such as trustees and pension fund managers are responsible for communicating their expectations to investment managers, including the extent to which ESG factors should be integrated into the investment management process.

On ESG criteria

Q7 Which ESG issues or criteria do you consider are most relevant for inclusion in your client's investment policy statement? For example, issues or criteria having to do with climate change, resource scarcity, pollution generally, reputation risks, human rights, and so forth.

Mercer:
Under most circumstances we prefer to not develop issue specific investment policies for clients. The rationale is that new issues emerge, new links to financial markets are formed and naming issues means that some will be left off the list. Instead we prefer to have policy statements cover ESG issues broadly and the client's definition of what is relevant from an investment perspective, and further, how these issues will be addressed. Also, as mentioned earlier, materiality should be a key consideration and since materiality of issues vary not only between industries but also over time, a dynamic ESG approach may have greater success than a static select issues approach.

Watson Wyatt:
Trustees are responsible for establishing a fund's Statement of Investment Principles and therefore have discretion to incorporate ESG objectives deemed relevant to the fund. As an investment consultant Watson Wyatt support our clients in developing and implementing a pragmatic sustainable investment policy but avoid directing clients to include any specific criteria. We believe this should be at the discretion of clients to ensure ESG criteria are relevant to their particular fund objectives, investment beliefs and governance arrangements. However, there are

some ESG themes that we believe will impact returns over the medium term and Watson Wyatt's Global Investment Committee is considering whether and how these could be incorporated into client portfolios.

Q8 In your view, can ESG fiduciary duty be discharged solely or primarily through exercise of voting rights? Please explain.

Mercer:
No. Though active ownership is a necessary part of an ESG or responsible investment strategy, it is not always conducted with care and purpose. Even if it is, voting rights do not exist across all asset classes and do not have the same impact across geographies in effecting corporate change. There needs to be some link to direct engagement with corporate directors and via investment decision making, if voting does not make an impact and the issue is a crucial one.

Watson Wyatt:
Where ESG factors have the potential to be financially material, the integration of these factors in the investment process could manifest itself in a variety of ways, just one of which is exercising voting rights attached to equities. Other means of integrating ESG factors might include moderated outcomes of investment analysis, engagement activity of varying intensities, or specific investment decisions. The most appropriate means of ESG integration should reflect the nature of the financial instruments being used and the particular investment strategy. For example, ESG integration in the context of passive investment strategies is principally limited to voting and engagement.

Q9 In your view, can ESG fiduciary duty be discharged solely or primarily through exercise of engagement and dialogue with company management? Please explain.

Mercer:
As above. Engagement does not guarantee results in itself and traditionally has been limited to governance issues, more than social and environmental considerations. We would look for some recourse for the portfolio manager if engagement is not successful over a reasonable time period. We would also seek some strategy for engagement beyond proxy related questions and a link between those engaging and those buying and selling within the investment management firm.

Watson Wyatt:
See answer to Q8

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Q10 In your view, does ESG fiduciary duty require taking action on whether one holds or refrains from holding certain stocks or bonds in a portfolio? Please explain.

Mercer:
No. In our view fiduciary duty does not require this unless the mission of the organization and the fund is such that holding certain companies or business activities within the portfolio would be viewed as objectionable by participants. Otherwise stock selection should be based on material ESG factors in conjunction with risk return characteristics.

Watson Wyatt:
Integrating ESG considerations into the investment process, where they are potentially financially material, could result in a variety of outcomes, one of which might lead to a decision to buy, hold or sell a specific security. However, we don't believe that ESG integration should necessarily require the exclusion of stocks, a decision which is more typically associated with

the implementation of client specific ethical and ESG screens.

Other possible outcomes of integrating ESG considerations might lead a portfolio manager to:

- change his/her view of company management and their ability to execute corporate strategy
- alter his/her opinion of the validity of financial metrics such as fair value, price targets, future earnings, profitability, liabilities etc.
- engage with company management to obtain more information and/or influence company management
- change stock and sector portfolio weightings.

On evaluating competence

Q11 Do you currently evaluate an asset manager's abilities to incorporate ESG factors in valuation or portfolio composition as part of your overall assessment of investment managers, regardless of whether a mandate calls for specific socially responsible investment, environmental investment, ethical investment, sustainable investment, or the like? If so, how much weight do you assign to this as part of your total evaluation or ranking? If not, do you have concrete plans to do so in 2008 or 2009?

Mercer:
Yes. The ESG rating is done in parallel with an overall investment rating and we allow the weighting/importance to be determined by the client.

Watson Wyatt:
We analyse the policy and practice of managers with regard to active share ownership and ESG integration in the investment process. This analysis relates to mainstream mandates and helps our clients monitor their manager's approach to active ownership.

At present we are in the process of further embedding analysis of managers' ESG integration capabilities into our routine manager research process. One recent development is a project we've initiated with eVestment Alliance which introduces a more systematic means of data collection on ESG via their investment manager database. The relevance given to these aspects in our assessment vary depending on the particular investment style, product, manager and asset class. This process is ongoing and involves training of the manager research team to understand the relevance of sustainability issues for their particular area of expertise. .

We are also actively considering sustainability themes that we believe will impact returns over the medium term to determine whether and how these could be implemented in client portfolios.

Q12 What criteria do you currently use to evaluate competence in ESG integration for purposes of a dedicated socially responsible investment mandate, environmental, ethical or similar mandate? Indicate relative weightings if you wish.

Mercer:
When conducting an assessment of ESG integration we look at the how ESG considerations impact idea generation, portfolio construction, management and implementation. This methodology is applied across all asset classes. How a strategy adheres to its stated objectives and policies is part of Mercer's overall investment rating whether the strategy is SRI or not. Where there are client specific screening requirements we qualitatively match those requirements to appropriate investment managers or strategies and confirm that the investment manager has the experience

and resources to implement such a strategy.
Our distinct ESG rating allows us to apply a single methodology consistently and transparently for clients. For an SRI or ethical mandate, a client may have specific requirements instead of or in addition to ESG integration. In these cases we use our standard investment rating, ESG rating, and a qualitative assessment of how client requirements are aligned with the investment manager's experience and approach.

Watson Wyatt:
Our manager research process involves an in-depth assessment based on numerous meetings with the portfolio managers and other relevant staff and analysis of data and portfolios. Our research is very thorough and employs a mix of qualitative and quantitative techniques to assess the skill and competencies of individual portfolio managers and/or investment teams. The research methodology is applied consistently to all manager research including sustainable investment products.

In terms of the way in which we analyse managers' ESG competencies for sustainable investment mandates we consider a broad range of issues such as the manager's prior ESG experience, their skill at accessing, collating and interpreting relevant information, (such as scientific, political and policy developments), as well as their ability to understand how these issues might impact future prospects of industries and specific stocks.

On proxy voting

Q13 Do you routinely investigate the proxy voting and engagement record of asset managers as concerns environmental and social issues? Or do you only do this if a mandate is specifically SRI, or ethical, or environmental, or the like? Please explain.

Mercer:
Reviews of proxy voting policies, resources, governance structures and records (where available) are part of our ESG manager research process which applies to all managers and strategies

Watson Wyatt:
On behalf of clients we review the policy and practice of incumbent managers with regard to active share ownership, including traditional corporate governance activities, proxy voting, and integration of material environmental and social factors. This relates to mainstream mandates rather than sustainable investment funds.

We routinely investigate the proxy voting practice of asset managers in relation to sustainable investment funds.

On requests for proposal (RFPs)

Q14 Do you habitually include questions on ESG policy, form of integration and competence on all RFPs, or only when mandates specifically call for ESG?

Mercer:
As consultants we normally issue RFPs on behalf of clients and would only include ESG if requested by the client. However, we recently sent a request for information to all managers in our Global Investment Manager Database requesting ESG integration information as part of our due diligence for clients.

Watson Wyatt:
Watson Wyatt's manager research and selection process does not make use of RFPs as we obtain

all necessary information from managers through our in-depth research process and ongoing dialogue.

On governing ESG in mandates

Q15 In your experience, do the typical timeframes for review and evaluation of manager financial performance discourage ESG integration? What improvements would you suggest?

Mercer:
No. Though we report to clients on quarterly performance, with some exceptions, we implement a 'watch list' policy with most clients assuring that managers aren't hired based on past performance and aren't fired based solely on recent poor performance. We attempt to instill an appreciation in our clients for holding long-term views.

Watson Wyatt:
Watson Wyatt recognises that placing too much emphasis on short-term investment performance can be detrimental to the pursuit of long-term performance goals. Where possible we encourage clients to take a long-term perspective implemented through dynamic investment strategies. Where performance is judged over short time periods the incentive for the manager to incorporate ESG considerations, which often play out over the medium to longer term, is less compelling. Performance judged over longer time horizons, particularly for long-term long only mandates, could incentivise managers to pay more attention to the potential impact of ESG factors on investment returns.

Q16 In your experience, is the prevalent incentive structure for managers neutral towards ESG integration, does it penalise, or does it promote such integration?

Mercer:
Neutral or perhaps penalizing. If incentives are distributed annually then the full value of ESG bets (in non-ESG themed portfolios) may not be recognizable.

Watson Wyatt:
Fee structures for investment managers vary significantly and may include a fixed management fee, a performance related fee or a combination of both. Watson Wyatt believes that well structured performance related fees, with appropriate high water marks and time horizons, can be beneficial to aligning the interests of clients and investment managers and are therefore desirable. Where ESG factors have potential to be financially material, investment managers rewarded, at least in part, by a performance related fee would in theory be incentivised to consider these factors. However, performance fees should be appropriately structured to avoid investment managers over emphasising short-term performance as this would be unlikely to incentivise them to consider ESG factors which typically play out over medium to longer term. Fixed management fees alone are unlikely to explicitly incentivise ESG integration as the manager is rewarded regardless of investment performance.

Q17 In your experience, is the prevalence of tracking error limits or index-referenced mandates neutral to or does it penalise ESG integration?

Mercer:
Probably penalizes. As consultants we understand the importance of tracking and benchmarking and so do our clients. However, we see a trend away from strict limits towards structures and policies more friendly to absolute return strategies. However, index tracking is still important for institutional investors as they need to establish a risk budget and ensure diversification. Tracking

error will likely be higher for some ESG integrated funds which means clients will expect a greater return. If this risk/reward does not seem balanced, clients may not want to take the risk. The practice of monitoring and evaluating short-term performance against a benchmark likely precludes integration of ESG by fund managers, as these factors may take some time to impact on valuations and the risk of deviating too far from the index on the basis of ESG considerations might be considered too risky. A longer time horizon and acceptance of greater deviation from the index for periods of time on the basis of less conventional criteria (such as ESG) therefore needs to evolve across the industry.

Watson Wyatt:
A portfolio which is guided by specific tracking error limits relative to a mainstream index may at times find it difficult to fully implement insights gained through ESG considerations as these might lead to a change in the tracking error target. Portfolios managed on an absolute return basis arguably have greater freedom to implement insights from ESG considerations as they are not constrained by a benchmark.

On legal language

Q18 Should legal language on ESG integration be part of investment management contracts between institutional investors and investment managers? Please explain. If you currently use such language, kindly attach these texts, or an example of text that you see as exemplary or best practice.

Mercer:
Yes, as long as institutions have investment policies to reflect that this is the case. However, we believe we have some ways to go before something like this can be implemented without severely limiting the investment options for an institutional investor. Not all managers, across geographies, asset classes and styles have the inclination or ability to abide by such language and it might be dangerous to include it otherwise. In addition, such language would probably be difficult to defend in a legal sense. However, there are institutions pursuing such language for mandates and others who are opening dialogues with existing managers on ESG.

Watson Wyatt:
Where a client has explicitly expressed specific ESG requirements or objectives there may be merit in including these in an investment management agreement. However, where clients have not explicitly expressed such requirements or objectives we would not support the inclusion of ESG integration wording in investment management agreements as a default because we are mindful that the relevance of ESG factors can vary depending on numerous factors.

Q19 In your view, should language on ESG integration be part of investment policy statements? Please explain. If you have model language, kindly attach such texts, or an example of text that you see as exemplary or best practice.

Mercer:
Yes, however we believe that there is no single approach to this issue. The financial materiality of ESG factors may vary across asset classes, geographies and fund manager skill so language among different institutions with different constituencies and different investment policies may vary.

Watson Wyatt:
Where a client has explicitly expressed specific ESG requirements or objectives these should be made clear in the investment policy statement. However, where clients do not have explicit

ESG requirements or objectives we would not support the inclusion of ESG integration wording in investment policy statements as a default.

Open-ended suggestions

Kindly outline your suggestions for obtaining better operationalisation of ESG integration in institutional investment concerning the question areas above or any other areas we may have overlooked.

Watson Wyatt:
[As part of their response, Watson Wyatt provided the following materials they have produced.]

- Investing for the future (January 2008)
- What is? Responsible ownership (January 2008)
- Unlocking future value in commercial real estate (October 2008)
- No action no option—A new era for active share ownership? (May 2009)

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Appendix D

Sample ESG provisions for investment mandates and investment management contracts

Arnold & Porter produced the following four sample ESG provisions, which were all endorsed by Quayle Watchman Consulting.

Sample 1:

<<<Client>>>'s investment objective is <<<investment objective>>>, provided that in pursuing such investment objective, <<<Asset Manager X>>> seeks to act in the best long-term interests of <<<Client>>>'s investors by taking into consideration environmental, social and corporate governance ('ESG') issues, to the extent permitted by law. <<<Asset Manager X>>> has signed the Principles for Responsible Investment ('PRI'). The PRI is an industry-focused initiative that promotes long-term responsible investment and share ownership, and the integration of material ESG issues into investment analysis. It is <<<Asset Manager X>>>'s intention to remain an active and engaged member of the PRI and meet any ongoing membership commitments (including the submission of an annual assessment questionnaire).

<<<Asset Manager X>>> is willing to make available to <<<Client>>> on request a copy of each assessment questionnaire that it submits to the PRI, as well as the PRI's analysis of its relative performance. Copies of the voting and engagement work undertaken within the context of the PRI are also available, upon request.

Sample 2:

<<<Client>>>'s investment objective is <<<investment objective>>>, provided that in pursuing such investment objective, <<<Asset Manager X>>> seeks to act in the best long-term interests of <<<Client>>>'s investors by taking into consideration environmental, social and corporate governance issues, to the extent permitted by law.

Sample 3:

Subject to compliance with applicable law, <<<Asset Manager X>>> shall be authorized to, and shall, take into consideration environmental, social and corporate governance issues in making investment decisions on behalf of <<<Client>>> in furtherance of <<<Client>>>'s investment objective. <<<Asset Manager X>>>, as a signatory to the Principles for Responsible Investment ('PRI'), shall manage the assets of <<<Client>>> in accordance therewith to the extent permitted by applicable law. <<<Asset Manager X>>> will promptly notify <<<Client>>> <<<Client's beneficial owners>>> in writing if its intention to remain engaged with PRI changes, for example, if the PRI materially changes in a way in which <<<Asset Manager X>>> does not support and will explain to <<<Client>>> <<<Client's beneficial owners>>> the rationale for withdrawing.

Sample 4:

Subject to compliance with applicable law, <<<Asset Manager X>>> shall be authorized to, and shall, take into consideration environmental, social and corporate governance issues in making investment decisions on behalf of <<<Client>>> in furtherance of <<<Client>>>'s investment objective.

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United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a strategic public-private partnership between UNEP and the global financial sector. UNEP works with over 180 banks, insurers and investment firms, and a range of partner organisations, to understand the impacts of environmental, social and governance issues on financial performance and sustainable development. Through a comprehensive work programme encompassing research, training, events and regional activities, 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.

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UNEP FI Asset Management Working Group

The UNEP FI Asset Management Working Group is a global platform of asset managers that collaborate to understand the ways that environmental, social and governance (ESG) issues can affect investment value, and to advance the integration of ESG issues into investment decision-making and ownership practices.

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Acuity Investment Management
AIG Investments
Aviva Investors
BNP Paribas Asset Management
Calvert Investments
ClearBridge Advisors
Eurizon Capital (Intesa Sanpaolo Group)
Groupama Asset Management
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HSBC Global Asset Management
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Endnotes

1 http://www.imf.org/external/pubs/ft/weo/2009/01/pdf/text.pdf

2 Source: FactSet

3 http://siteresources.worldbank.org/INTGEP2009/Resources/5530448-1238466339289/GEP-Update-March30.pdf

4 www.unep.org/greeneconomy

5 Freshfields Bruckhaus Deringer, A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment (2005), UNEP FI Asset Management Working Group
http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf

6 For a comprehensive review of research on responsible performance, see: Demystifying Responsible Investment Performance – A Review of Key Academic and Broker Research on ESG Factors (2007), UNEP FI Asset Management Working Group and Mercer http://www.unepfi.org/fileadmin/documents/Demystifying_Responsible_Investment_Performance_01.pdf

7 For a detailed discussion of the types of responsible investment strategies, see Appendix B.

8 Hansard, HL (7 October, 2008)

9 Ibid.

10 http://www.equator-principles.com

11 http://www.unglobalcompact.org

12 For example, where the account is organized as a limited partnership, the limited partnership agreement would be the logical document in which an ESG provision may be included. Alternatively, where the account is a collective investment vehicle organized as a business trust, the declaration of trust or similar document would be the logical document in which an ESG provision may be included.

13 Freshfields Bruckhaus Deringer, A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment (2005), UNEP FI Asset Management Working Group http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf

14 For a comprehensive review of research on responsible investment performance, see: Demystifying Responsible Investment Performance – A Review of Key Academic and Broker Research on ESG Factors (2007), UNEP FI Asset Management Working Group and Mercer http://www.unepfi.org/fileadmin/documents/Demystifying_Responsible_Investment_Performance_01.pdf

15 This is the first iteration of the UNEP FI Asset Management Working Group's 'Materiality Series', as follows:
In 2004, The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing ('Mat I'):
http://www.unepfi.org/fileadmin/documents/amwg_materiality_equity_pricing_report_2004.pdf
In 2006, Show Me The Money – Linking Environmental, Social and Governance Issues to Company Value ('Mat II')
http://www.unepfi.org/fileadmin/documents/show_me_the_money.pdf
Upcoming in 2009, The Materiality of Climate Change – How Finance Copes With The Ticking Clock ('Mat III')

16 http://www.unpri.org/faqs/

17 http://www.pionline.com/article/20080901/CHART2/23723097/-1/WWTOPFUNDS and http://www.unpri.org/signatories/

18 For best practice case studies on responsible investment approaches, see: Responsible Investment in Focus: How Leading Public Pension Funds Are Meeting The Challenge (2007), UNEP FI Asset Management Working Group and the UKSIF Sustainable Pensions Project http://www.unepfi.org/fileadmin/documents/infocus.pdf

19 http://www.accessmylibrary.com/coms2/summary_0286-29710812_ITM

20 http://www.csreurope.org/news.php?type=&action=show_news&news_id=925

21 http://www.citywire.co.uk/Adviser/-/news/green/content.aspx?ID=313653

22 For good practices regarding ESG integration in the institutional investment consultant industry, see Appendix C

23 See 'Part III – Practical developments on the integration of ESG into the investment process'

24 See Quayle Watchman Consulting's relevant commentary under 'Part I – Legal commentary on fiduciary duty and the implementation of ESG in investment mandates'

25 http://www.sustainablebusiness.com/index.cfm/go/news.display/id/16804

26 Environmental, Social and Governance Factors at Listed Companies: A Manual for Investors (2008), CFA Institute http://www.cfainstitute.org/aboutus/press/release/08releases/20080625_01.html

27 See 'Part III – Practical developments on the integration of ESG into the investment process'

28 For a detailed discussion of the types of responsible investment strategies, see Appendix B

29 Section 417 of the Companies Act 2006

30 Sections 172-177 of the Companies Act 2006

31 DTI Companies Bill Guidance (June 2007) p 2

32 DTI Companies Bill Guidance p 7

33 See below pp. 33-34

34 See Freshfields Report generally.

35 Freshfields Report (2005)

36 Friends of the Earth, [Xstrata Report]

37 Leon Gettler, 'Big funds warned on negligence', The Age, 30 November 2005

38 Benjamin J. Richardson, Socially Responsible Investment Law: Regulating the Unseen Polluters, Oxford University Press (2008) p 541

39 Rt. Hon. Mike O'Brien, Minister of State for Pensions Reform, 21 May 2008

40 Hansard, HL (7 October, 2008)

41 Ibid.

42 http://www.equator-principles.com

43 http://www.unglobalcompact.org

44 For a comprehensive glossary of responsible investment terms, see: Demystifying Responsible Investment Performance – A Review of Key Academic and Broker Research on ESG Factors (2007), UNEP FI Asset Management Working Group and Mercer http://www.unepfi.org/fileadmin/documents/Demystifying_Responsible_Investment_Performance_01.pdf

45 Benjamin J. Richardson, Do the Fiduciary Duties of Pension Funds Hinder Socially Responsible Investment?, Banking and Finance Law Review (2007)

46 Darfur Task Force

47 Freshfields Report, ibid.

48 For example, where the account is organized as a limited partnership, the limited partnership agreement would be the logical document in which an ESG provision may be included. Alternatively, where the account is a collective investment vehicle organized as a business trust, the declaration of trust or similar document would be the logical document in which an ESG provision may be included.

49 We [Arnold & Porter] note, however, that in many cases the damages for such a breach may be speculative and difficult to prove.

50 The Sample Provisions were prepared for accounts generally and thus would not be suitable for use in documents internal to employee benefit plans.

51 For a practical example, see the report produced by the UK Environmental Agency Pension Fund on their 2008 RFP experience as part of the implementation of their global equity mandates: http://www.environment-agency.gov.uk/static/documents/GblEqtyRev.pdf

52 Tier 1 – USD 2 trillion to 4 trillion; Tier 2 – USD 1 trillion to 2 trillion; and Tier 3 less than USD 1 trillion.

53 For a comprehensive glossary of responsible investment terms, see: Demystifying Responsible Investment Performance – A Review of Key Academic and Broker Research on ESG Factors (2007), UNEP FI Asset Management Working Group and Mercer http://www.unepfi.org/fileadmin/documents/Demystifying_Responsible_Investment_Performance_01.pdf

54 Freshfields Report

55 We [Arnold & Porter] note, however, that in many cases the damages for such a breach may be speculative and difficult to prove.

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69 The UNEP FI Insurance Working Group comprises Achmea (Netherlands), AIG (US), Allianz (Germany), Aviva (UK), AXA (France), Folksam (Sweden), HSBC Insurance (UK), Insurance Australia Group (Australia), Interamerican Hellenic Life (Greece), Lloyd's (UK), MAPFRE (Spain), Munich Re (Germany), RSA (UK), Storebrand (Norway), Swiss Re (Switzerland), The Co-operators Group (Canada), Tokio Marine Nichido (Japan), and XL Capital (Bermuda).

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73 [1985] Ch 270.

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75 The single judge presiding in Cowan, Megarry VC, has since disavowed claims that the Cowan decision prevents institutional investors from considering the non-financial impacts of an investment (see Richardson, 2008).

76 See the Uniform Prudent Investor Act, comment to § 5.

77 See e.g. Langbein and Posner, 'Social Investing and the Law of Trusts', (1980) 79 Mich. L. Rev. 72.

78 See letter from the US Department of Labor to William M. Tartikoff, Senior Vice President and General Counsel of Calvert Group Ltd. (28 May 1998) (the 'Calvert Letter') http://www.calvert.com/nrc/literature/documents/sri_dol_letter.pdf?litID=DOLSRI

79 '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' (UNEP FI, 2005, p 11).

80 The average score given in agreement with this statement was 1.9, on a scale where 1 = agree fully and 6 = totally disagree.

81 29 CFR §2509.08-1

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