THE CAPCO INSTITUTE

JOURNAL

OF FINANCIAL TRANSFORMATION

ESG

ESG and the duties of investment managers examined

DANIEL NEVZAT | IMOGEN GARNER

WEALTH & ASSET MANAGEMENT

#51 APRIL 2020

THE CAPCO INSTITUTE

JOURNAL OF FINANCIAL TRANSFORMATION

RECIPIENT OF THE APEX AWARD FOR PUBLICATION EXCELLENCE

CONTENTS

INVESTMENTS

TECHNOLOGY

ESG

DEAR READER,

Welcome to edition 51 of the Capco Institute Journal of Financial Transformation.

The global wealth and asset management industry faces clear challenges, and a growing call for innovation and transformation. Increased competition, generational shifts in client demographics, and growing geopolitical uncertainty, mean that the sector needs to focus on the new technologies and practices that will position for success, at speed.

There is no doubt that technology will be at the forefront of a responsive and effective wealth and asset management sector in 2020 and beyond. The shift to digitization, in particular, will see the speeding up of regulatory protocols, customer knowledge building, and the onboarding process, all of which will vastly improve the client experience.

This edition of the Journal will focus closely on such digital disruption and evolving technological innovation. You will also find papers that examine human capital practices and new ways of working, regulatory trends, and what sustainability and responsible investment can look like via environmental, social and corporate governance.

As ever, I hope you find the latest edition of the Capco Journal to be engaging and informative. We have contributions from a range of world-class experts across industry and academia, including renowned Nobel Laureate, Robert C. Merton. We continue to strive to include the very best expertise, independent thinking and strategic insight for a future-focused financial services sector.

Thank you to all our contributors and thank you for reading.

Lance Levy, **Capco CEO**

ESG AND THE DUTIES OF INVESTMENT MANAGERS EXAMINED

DANIEL NEVZAT | Manager, Government Relations and Public Policy Practice, Norton Rose Fulbright LLP
IMOGEN GARNER | Partner, Financial Services Group, and Head, Buy-side Regulatory Practice, Norton Rose Fulbright LLP

ABSTRACT

There has been a shift in thinking among industry stakeholders, policymakers, and regulators alike towards viewing environmental, social and governance (ESG) issues as financial risks that can have a material impact on investment performance. This has resulted in legislative and regulatory changes in the U.K. and the E.U., seeking to clarify that ESG issues are financially material, which may in turn impact the interpretation of investment managers' fiduciary duties, tortious and contractual duties, as well as their regulatory duties. This article will discuss the duties of investment managers, consider how ESG issues interact with those duties, and explore how recent legislative and regulatory changes may impact the applicable legal liability regime.

1. INTRODUCTION

Investment managers owe duties to their clients, where they exercise discretionary power over their portfolios. The duties by which investment managers are bound fall into four main categories: a (tortious) duty to exercise due skill, care and diligence, fiduciary duties of trust and loyalty, contractual duties as set out under the Investment Management Agreement (IMA), and duties arising from the regulatory framework. There is significant interplay between these duties: the principles underlying fiduciary and tortious duties have influenced the regulatory framework, and regulatory rules and guidance help define the scope of duties applied at common law. This article will discuss the duties of investment managers, consider how environmental, social and governance (ESG) issues interact with those duties, and explore how recent legislative and regulatory changes may impact the applicable legal liability regime.

It has been the subject of extensive debate whether investment managers and other institutional investors are permitted and/or required to consider ESG issues when discharging duties to their clients or beneficiaries. Institutional investors have traditionally viewed their duties as being defined exclusively by the pursuit of financial returns, causing them necessarily to dismiss the consideration of ESG issues as being ethical or moral considerations that should not be taken into account. However, there has been a shift in thinking among industry stakeholders, policymakers, and regulators alike towards viewing ESG issues as financial risks that can have an impact on investment performance. This has resulted in legislative and regulatory changes in the U.K. and E.U., seeking to clarify that ESG issues are financially material, which may in turn impact the interpretation of investment managers' fiduciary duties, tortious and contractual duties, as well as their regulatory duties.

2. FIDUCIARY DUTIES

The underlying feature of fiduciary duties is the obligation of loyalty and fidelity, as opposed to a duty to act competently, which is covered by tortious and contractual duties. The core duties that a fiduciary must uphold at all times are: (1) a duty to avoid acting where there is a conflict between the fiduciary's duty and his or her own interests, or a conflict between duties owed to multiple principals (no conflict rule) and (2) a duty not to make an unauthorized profit from the fiduciary's position (no profit rule).[1] These are negative duties, in that that they proscribe a fiduciary from engaging in disloyal or dishonest conduct.[2] While there may also be a positive duty for the fiduciary to act in the best interests of the principal, this can be viewed as a combination of the established duties and not a separate duty. It should be remembered that the recast Markets in Financial Instruments Directive (MiFID II) requires firms to act honestly, fairly, and professionally in accordance with the best interests of their clients when providing investment services or ancillary services, which can be viewed as a positive (regulatory) duty with fiduciary characteristics.[3]

In addition, a duty to act in good faith may be considered a fiduciary duty,[4] but a fiduciary would be held to account for breaching the core duties even where he/she has acted honestly and well-intentioned.[5] It should be noted that the IMA typically purports to exclude the general application of fiduciary duties to the investment manager, as under the Investment Association's Model IMA.[6] As a general rule, such terms will be upheld on the basis that the scope of fiduciary duties is to be defined by the terms of the agency contract, so long as they are clear, unambiguous, and reasonable, and are consistent with the limits imposed at common law on the construction of exclusion clauses.[7]

There are important questions around whether the consideration of ESG factors is consistent with the fiduciary duties of investment managers and other institutional investors. There has been a series of research papers, coordinated by the United Nations Environment Program Finance Initiative (UNEP FI), analyzing fiduciary duties and the consideration of ESG factors on a cross-jurisdictional basis. Three reports have been published so far: the Freshfields Report (2005),[8] Fiduciary II (2009),[9] and Fiduciary Duty in the 21st Century (2015).[10] The central argument of the UNEP FI is that the integration of ESG considerations into investment decision making is consistent with the fiduciary duties of institutional investors, as these are long-term investment value drivers.[11] As such, UNEP FI concludes that investment approaches that take into account ESG factors are clearly permissible and arguably required.

Investment managers will generally be permitted to consider ESG factors in the investment process where they are aligned to the objectives of the portfolio. Given that the purpose of the portfolio is normally to produce a financial return for the investor, the incorporation of ESG principles must be consistent with this core objective. According to Cowan v Scargill, a case concerning pension fund trustees where the purpose of the fund is the provision of financial benefits, the best interests of the beneficiaries are normally their best financial interests, without reference to moral or political considerations.[12] Furthermore, Martin v Edinburgh District Council provides that there is a duty not to fetter investment discretions for extraneous reasons, such as those of a political or moral nature.[13] While not focused specifically on modern ESG investing, these judgments indicate that fiduciary duties require the manager to pursue the client's financial objectives where this is the purpose of the portfolio's mandate. As such, there is no legal basis for an investment manager to prioritize moral or ethical considerations over financial performance, unless agreed under the mandate. However, the consideration of ESG factors may also contribute to achieving the client's financial objectives, which means that there can be an alignment of ethical considerations and financial returns. The consideration of ESG factors may be compatible with a requirement to serve the client's best interests even where fiduciary duties are defined by the pursuit of financial returns, so long as this is undertaken in order to promote the client's financial objectives rather than the ethical views of the investment manager.

1 Law Commission, 2014, "The fiduciary duties of investment intermediaries," (Law Com No 350, 2014), para. 3.28.
2 Attorney-General v Blake [1998] Ch 439 [455].
3 Directive 2014/65/EU on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU [2014] OJ L173, Article 24(1).
4 Bristol and West Building Society v Mothew [1997] 2 WLR 436 [18].
5 Regal (Hastings) Ltd v Gulliver [1967] 2 AC 134 (HL) [142].
6 The Investment Association, 2018, "Model discretionary investment management agreement," May, accessed 24 September 2019, Clause 20.
7 Kelly v Cooper [1993] AC 205
8 United Nations Environmental Programme Finance Initiative, 2005, "A legal framework for the integration of environmental, social and governance issues into institutional investment," https://bit.ly/2RkbeQA
9 United Nations Environmental Programme Finance Initiative, 2008, "Fiduciary responsibility legal and practical aspects of integrating environmental, social and governance issues into institutional investment," https://bit.ly/2FVZpe4
10 United Nations Environmental Programme Finance Initiative, 2014, "Fiduciary duty in the 21st Century," https://bit.ly/373muYg
11 Principles for Responsible Investment, 2015, "Fiduciary duty in the 21st Century," September 8, accessed 30 August 2019, p 16.
12 Cowan v Scargill [1984] 3 WLR 501.
13 Martin v Edinburgh District Council [1988] S.C.L.R. 90.

The amended Occupational Pension Scheme (Investment) Regulations 2005 (OPS Regulations) define "financially material considerations" as including ESG factors.[14] This puts on a statutory footing the concept that ESG factors contribute to financial performance, and, therefore, that the incorporation of ESG factors is consistent with fiduciary duties, where defined in terms of the beneficiary's best financial interests. Although the OPS Regulations are applicable to pension fund trustees, the amendment may also influence the interpretation of the fiduciary duties of investment managers, such that the incorporation of ESG factors would be deemed consistent with pursuing financial returns on clients' portfolios. In addition, the IMA between the investment manager and the pension fund trustee will usually include a term requiring the former to comply with the latter's statement of investment principles (SIP). The SIP must cover inter alia the pension fund trustee's policies in relation to financially material considerations over the appropriate time horizon of the investments, including how these are taken into account in the selection, retention, and realization of investments.[15] A direct obligation would, therefore, be imposed on investment managers to consider ESG factors as financially material considerations in managing pension fund assets, where they are required to comply with the SIP under contract. It should also be noted that trustees will need to disclose in the SIP how they incentivize asset managers to align their investment strategy and decisions with the trustees' policies.[16] This creates a "comply or explain" obligation for pension fund trustees to incentivize the investment manager to incorporate ESG objectives into its investment approach through alignment with the trustee's policies.

It is also significant that the E.U. Sustainability-related Disclosures Regulation defines "sustainability risk" as an ESG event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment.[17] The concept that ESG factors impact on financial returns is, therefore, also set to be codified under E.U. law applicable to financial market participants and financial advisors. This provides further support for the position that ESG factors should be considered by investment managers where fiduciary duties are characterized by a requirement to pursue the client's best financial interests.

The consideration of ESG factors must support the investment strategy and objectives agreed with the client to ensure that his or her financial interests are prioritized. Whether the client has a short-term or long-term time horizon may be particularly significant in determining alignment of ESG factors with the client's financial objectives. It has traditionally been argued by proponents of ESG investing that such strategies produce stronger and more sustainable returns in the long term, rather than the short term. Indeed, in the U.K. government's response to "Clarifying and strengthening trustees' investment duties", it states that, while the risks and opportunities presented by ESG factors are not exclusively long term, they often are long term, as the risks from mispricing assets increases as time passes.[18] If the financial benefits of incorporating ESG factors only materialize in the long term, it may be considered that the client's best interests would only be served where he or she has instructed the manager to pursue a long-term time horizon. As such, where the client has a short-term time horizon, it may not be in the client's best interests to incorporate ESG factors as the financial benefits of such a strategy may not materialize within this timeframe.

However, one notable exception to the view that the financial benefits of ESG investing are long term is the impact of climate change on the performance and risk profile of financial institutions. The U.K.'s Prudential Regulation Authority (PRA) recently stated that, while the financial risks from climate change may crystallize in full over longer time horizons, they are also becoming apparent now.[19] The PRA considers that the financial risks from physical and transition risk factors are far-reaching in breath and magnitude, and while the time horizons over which financial risks may be realized are uncertain, there is a high degree of certainty that such risks will occur. This may indicate that, in order to serve the client's best financial interests, investment managers should at least consider the extent to which companies mitigate the risks associated with climate change in the investment decision making process, even where the client has a short-term horizon. Although

[14] The Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018, SI 2018/988, Regulation 4.

[15] The Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2019, SI 2019/982, Regulation 2(3)

[16] The Occupational Pension Schemes Regulations 2019 (n 15), Regulation 2(4).

[17] Regulation (E.U.) 2019/2088 on sustainability-related disclosures in the financial sector [2019] OJ L317/1, Article 2(24).

[18] Department for Work & Pensions, Clarifying and strengthening trustees' investment duties: Government response; The Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2018 (now the Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018) (2018), 19-20.

[19] Prudential Regulation Authority, 2019, "Enhancing banks' and insurers' approaches to managing the financial risks from climate change," Supervisory Statement 3/19

investment managers are not typically subject to PRA regulation, the statement could suggest a broader shift in regulatory thinking around climate change risk.

Stewardship or "active ownership" by institutional investors is a core component of an effective ESG investing strategy. The "Proposed Revision to the UK Stewardship Code" proposes to make explicit references to ESG factors, reflecting the significant developments that have taken place in sustainable finance, responsible investment, and stewardship since the Stewardship Code (the Code) was last updated in 2012. Under the draft proposals, signatories would be expected to take into account material ESG factors, including climate change, when fulfilling their stewardship responsibilities. It should be noted that the FCA requires all U.K. investment managers to disclose the nature of their commitment to the Code or, where they do not commit to the Code, their alternative investment strategy.[20] While the Code is not binding on investment managers, the draft proposals will have the effect of defining the investment manager's fiduciary duties as consistent with incorporating ESG factors in fulfilling their stewardship responsibilities.

3. DUTY OF CARE

A duty to exercise due skill, care, and diligence is owed by investment managers to their clients, which requires them to meet a certain standard of care when selecting and acquiring or disposing of investments for the clients' portfolios. It should be noted that, while the relationship between the parties can also give rise to concurrent duties of care in tort and contract, the scope of this duty is the same as that expressly set out in the contract.[21] A breach of the duty of care will result where the manager falls below the standard of care, defined by reference to that expected of an ordinary investment manager who professes to have the skills required to service the type of portfolio in question. Given the high level of sophistication in modern investment management and specialist skills that managers are expected to possess in relation to specific asset classes, markets, and strategies, the standard of care should be tailored to the type of portfolio. For example, the expertise required to manage a portfolio of equities would differ significantly to one of bonds or derivatives, as would a long-term strategy compared with a short-term strategy. Where specific expertise is required to effectively manage the client's portfolio in accordance with the agreed investment strategy, this is reflected in the standard of care expected of the manager.

> *"Regulatory rules and guidance may have the effect of creating obligations at common law for investment managers to consider climate change risks, as such standards serve as a baseline for determining the standard of care applied by the courts."*

As the regulatory framework concerning climate change and other ESG issues continues to develop, rules and guidance may have the effect of creating obligations at common law for investment managers to consider climate change risks, as such standards serve as a baseline for determining the standard of care applied by the courts. In Shore v Sedgwick Financial Services, it was stated that the skill and care to be expected of a reasonably competent advisor ordinarily includes compliance with regulatory rules,[22] and in Seymour v Caroline Ockwell, while the duty of care owed at common law is not necessarily co-extensive with the duties owed under the regulatory regime, this afforded strong evidence as to what is expected of a competent advisor in most situations.[23] However, according to Gorham v British Telecommunications, the courts are not excluded from making their own assessment, but may determine the standard of care in the context of rules and codes of practice and are expected to attach considerable weight to them.[24] This principle of using regulatory rules and guidance to interpret the standard of care may also apply where duties arise from contract, as in SPL Private Finance v Arch Financial Products, where the court was prepared to interpret a term of the IMA in line with "principles of good market practice", referring to the FCA Principles for Business.[25]

[20] Financial Conduct Authority, Conduct of business sourcebook, Handbook, 2.2.3 R.
[21] South Australia Asset Management Corp v York Montague Ltd [1997] AC 191 (HL) [211].
[22] Shore v Sedgwick Financial Services Ltd [2007] EWHC 2509 [161].
[23] Seymour v Caroline Ockwell & Co [2005] EWHC 1137 [77].
[24] Gorham v British Telecommunications Plc [2000] 1 WLR 2129 [2141].
[25] SPL Private Finance (PF1) IC Limited and 17 Others v Arch Financial Products LLP [2014] EWHC 4268 [178]. The relevant term pertained to the management of conflicts of interest, but may nevertheless indicate the court's willingness to interpret the contractual duty of care in line with regulatory rules and guidance.

It is significant that the FCA has set out its objective to ensure that regulated financial services firms integrate consideration of long-term climate change risks and opportunities into the business, risk, and investment decisions they make, where such long-term considerations are appropriate.[26] The FCA will expect that regulated financial services firms consider climate change risks and opportunities in both the design and delivery of their products, which includes both segregated portfolios and pooled funds.

There is a regulatory expectation that investment managers and other firms should take steps to integrate climate change risks and opportunities. Although the FCA has not yet published final rules and/or guidance on climate change and green finance, it is anticipated that such measures will be introduced in due course. Furthermore, if the U.K. implements the Sustainability-related Disclosures Regulation, financial market participants (including investment managers) would be required to disclose how they integrate sustainability risks into their investment decision-making processes.[27] This could lead to a position where investment managers attract private law liability for failing to take climate change and other sustainability risks into account and/or such matters were not adequately disclosed to the client, in particular where this causes a significant decrease in value of the client's portfolio. The standard of care applicable to the manager at common law would be interpreted in line with the applicable regulatory framework, which may include expectations around managing the risks from climate change appropriately.

[26] Financial Conduct Authority, 2019, "Climate change and green finance: summary of responses and next steps, Feedback to DP18/9," Feedback Statement 19/6

[27] The UK's decision to withdraw from the European Union has created some uncertainty around whether the UK will implement the legislation under the EU Sustainable Finance Action Plan.

4. CONCLUSION

It is becoming increasingly clear that investment managers must consider ESG factors in discharging their duty of care and fiduciary duties to their clients. For the first time, the concept that ESG factors are financially material considerations has been codified in U.K. statute, putting it beyond doubt that pension fund trustees are permitted to take such matters into account when serving their clients' best financial interests. This will have a broader impact on how institutional investors, such as investment managers, think about their duties to their clients and that they need to consider a wider range of issues when pursuing their clients' best financial interests, particularly in the longer term. While at present climate change risk is high on the supervisory agenda – perhaps reflecting political trends – it is highly likely that regulators will extend their focus to other ESG issues and introduce rules and guidance compelling investment managers and other regulated firms to incorporate ESG into their financial decision making processes. These trends point to increased legal and regulatory risk and the potential for investment managers to be held to account for losses related to inadequate consideration of ESG issues. In this fast-moving area of law and regulation, it is vital that investment managers and other regulated firms are aware of their obligations in relation to ESG and take active steps to ensure that such risks to their clients and business are appropriately managed.

ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward.

Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize primarily in banking, capital markets, wealth and asset management and insurance. We also have an energy consulting practice in the US. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

WORLDWIDE OFFICES

APAC
Bangalore
Bangkok
Hong Kong
Kuala Lumpur
Pune
Singapore

EUROPE
Bratislava
Brussels
Dusseldorf
Edinburgh
Frankfurt
Geneva
London
Paris
Vienna
Warsaw
Zurich

NORTH AMERICA
Charlotte
Chicago
Dallas
Houston
New York
Orlando
Toronto
Tysons Corner
Washington, DC

SOUTH AMERICA
São Paulo