ICGN
International Corporate Governance Network

ICGN Guidance

Implications of Fiduciary Duty for Institutional Investors

A Global Overview of Investor Duties and Responsibilities

Introduction

This ICGN Guidance discusses issues to be addressed in the alignment between investor fiduciary practices and fundamental fiduciary obligations. It addresses the perspective of investor fiduciaries who seek to achieve a high level of success in serving beneficiary interests over time. The Guidance was developed by ICGN investor members, and is intended to offer an institutional investment practitioner perspective of how fiduciary duties and responsibilities take shape when applied to the management of financial assets.

The Guidance complements, and builds from, ICGN's Global Stewardship Principles[1], first published in 2003 and revised in 2016, as well as the ICGN Model Mandate (2014)[2] and the Global Governance Principles (2015)[3]. The Guidance aims to serve as a useful resource for the broader investor community and is organised around the following investor fiduciary governance concerns.

1. Fundamental Fiduciary Duty Principles
2. Systemic Risk and Financial Market Stability
3. Appropriate Time Horizons
4. Materiality of Environmental, Social and Governance Factors
5. Fiduciary Duty in the Investment Chain
6. Reporting and Accountability

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[1] ICGN Global Stewardship Principles: http://icgn.flpbks.com/icgn-global-stewardship-principles/#p=1

[2] See ICGN Model Mandate: http://icgn.flpbks.com/icgn_model-contract-terms_2015/#p=1

[3] See ICGN Global Governance Principles: http://icgn.flpbks.com/icgn-global-governance-principles-2017/

Background

Much has changed in the investment industry since the beginning of the 21st century, with further implications for institutional investor fiduciaries. Today, a plethora of country corporate governance codes, investor stewardship codes, and related guidance or regulations continues to emerge around the globe, reflecting unprecedented focus on the role of asset managers and asset owners as investor fiduciaries. Markets are criticised as increasingly short-term, while the investment chain has become more global and complex. The landscape of financial risks has correspondingly evolved.

Fiduciary duty concepts are fundamental to informing institutional investors' views of risk and materiality, which extend beyond quarterly calls, financial statements and recent share price movements. Institutional investors must be concerned with financial performance that meets their fiduciary obligations, which typically extend over a long-term time horizon. This has driven a growing focus on material, industry-specific, environmental, social and governance (ESG) performance and systemic risk indicators, as well as on the need for liquidity, to meet both current and future funding obligations to their ultimate beneficiaries.

Formal guidance regarding Fiduciary duty concepts continues to evolve, inspired by the issuance of various academic and professional studies, as well as government regulation-- such as the European Commission's Shareholder Rights Directive (effective March 2019), which requires institutional investors to disclose how they take the long-term interests of their beneficiaries into account. This includes how they incentive external managers and implement company engagement policies. Investors are also required to disclose engagement policies including their implementation. Additional guidance includes European Union's High Level Expert Group 2018 report on Sustainable Finance and the Principles for Responsible Investment's (PRI) detailed legal review of fiduciary duty and ESG in diverse global jurisdictions in 2015[4].

The fiduciary relationship between those to whom power is entrusted to invest (the "**investor fiduciaries**") and the fund beneficiaries sets the stage for developing governance policies and practices of institutional investors. This Fiduciary Duty Guidance highlights the importance of maintaining consistency between investors' governance practices and investors' fiduciary responsibilities.

This Fiduciary Duty Guidance also outlines how institutional investors may address and align their respective governance frameworks and investment strategies with their fiduciary duties. While standards of implementation for institutional investor fiduciary duties vary across markets and legal environments, and over the course of time, the fundamental fiduciary principles which underpin those standards should remain consistent.

[4] See the European Commission Action Plan for Financing Sustainable Growth (March 2018) at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018DC0097&from=EN and Rory Sullivan, Will Martindale, Elodie Feller and Anna Bordon, Fiduciary Duty in the 21st Century (September 2015) at http://www.unepfi.org/fileadmin/documents/fiduciary_duty_21st_century.pdf

[5] The RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 (1992) provides an overview of common law fiduciary duty for investor fiduciaries. Civil law markets typically use similar statutory or regulatory provisions which identify investor duties and responsibilities that address the same underlying dynamics of institutional asset owner and investment manager obligations to fund participants. See Keith L. Johnson, Introduction to Institutional Investor Fiduciary Duties, International Institute for Sustainable Development (February 2014), at https://www.iisd.org/library/introduction-institutional-investor-fiduciary-duties.

The concepts of guardianship and trust lie at the heart of fiduciary duty. Investor fiduciaries who serve as investment managers have, by definition, been assigned authority to manage funds on behalf of asset owners. In turn, asset owners also have fiduciary obligations to their end beneficiaries. Nearly all markets have legal mechanisms in place to protect fund beneficiaries from harm at the hands of third party agents. Fiduciary duties exist to safeguard the current and future interests of fund beneficiaries, both to enhance value and to protect them from potential misuse of their assets, owing to negligence, conflicts of interest (or agency issues) and/or incompetence of their investor fiduciaries.

It is vital that the investor fiduciary adopts stewardship practices which allow it to effectively discharge its fiduciary duty over appropriate time horizons. Institutional investors are stewards of an ever-growing percentage of global investible assets. This rapid growth in the institutionalisation of savings has increased the influence of investor fiduciaries in capital markets, with corresponding systemic effects reflective of the institutional investor viewpoint. As markets have become more complex and institutional investors' asset allocations have become increasingly global and diversified, the investment service provider sector has also grown. Most investor fiduciaries outsource or contract with multiple external managers, advisors and consultants to gain expert advice and broader exposure to markets, asset classes or industry sectors. This practice serves to highlight the importance of alignment between the investor fiduciary's governance practices and its fundamental fiduciary obligations.

Part I - ***Fundamental Investor Fiduciary Duty Principles***

Investor fiduciaries hold a unique position of trust, requiring strict standards of conduct. The term "fiduciary duties" in this Guidance refers to core procedural and behavioural tenets that a fiduciary entity is expected to uphold as it acts to protect and steward assets on behalf of current and future beneficiaries.[5] In fact, the word, "fiduciary" originates from the Latin word, "fiducia," which connotes a relationship of trust, confidence, and reliance.

While terminology, legal constructs and behavioural interpretations may vary between entities, across jurisdictions, and over the course of time, the overarching fiduciary principles relevant to sustainable investment practices remain relatively constant.[6] Viewed as behavioural standards for the processes governing conduct of investor fiduciaries, these principles focus on governance practices and the integrity of related processes.

There are two central principles which typically form the core of fiduciary duties:

- Duty of Care or the Duty of Prudence, which is intended to protect beneficiaries from negligence and incompetence of the fiduciary. The world "prudence" is derived from the

[5] The RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 (1992) provides an overview of common law fiduciary duty for investor fiduciaries. Civil law markets typically use similar statutory or regulatory provisions which identify investor duties and responsibilities that address the same underlying dynamics of institutional asset owner and investment manager obligations to fund participants. See Keith L. Johnson, Introduction to Institutional Investor Fiduciary Duties, International Institute for Sustainable Development (February 2014), at https://www.iisd.org/library/introduction-institutional-investor-fiduciary-duties.

[6] The PRI has a work programme that has developed a number of resources covering fiduciary duty and investor duties and responsibilities across a range of common and civil law jurisdictions, with a main focus on the link between ESG related factors and fiduciary duty. See https://www.unpri.org/sustainable-markets/sustainable-financial-system/fiduciary-duty.

Latin "prudentia," which means use of forward-looking wisdom and discretion that is cautious and careful;

- Duty of Loyalty, which requires the fiduciary to serve the interests of the asset owner and fund beneficiaries first and foremost, in order to guard against personal bias, misuse and self-dealing by the fiduciary.

This Guidance seeks to further distill fundamental global principles of fiduciary duty which includes, but extends beyond, an ESG focus – and which is distinct from specific, legal jurisdictional frameworks that apply to each institution. The following list, which summarizes these meta-principles, is not intended to be prescriptive or exhaustive, however ICGN believes they may serve to guide institutional investor fiduciaries, regardless of jurisdiction, law, regulation or custom.[7]

- Precautionary "Do No Harm Principle," which recognizes the unique dependence of beneficiaries on their investor fiduciaries. This principle recognises that investor fiduciaries may, whether intentionally or inadvertently, cause harm to those they are entrusted to protect. The notions of social contract and legitimacy are also related to the Do No Harm Principle and inform the need to manage investment decisions so as to avoid or minimize negative environmental or social impacts, with potentially adverse consequences for beneficiaries;

- Duty of Impartiality, which recognizes that different classes or types of beneficiaries may have interests which conflict or diverge from each other and may be viewed within the context of the Duty of Loyalty. The duty of impartiality is core to the concept of sustainability, as it recognizes varying generational time horizons, investment risk tolerances and long-term capital growth expectations. It contemplates an obligation to identify, consider and attempt to balance competing beneficiary interests, while recognizing that absolute impartiality between generations of beneficiaries may not always be possible;

- Duty to Maintain Adequate Diversification at the Total Fund Level. This is an aspect of prudence. Diversification across asset classes and global markets may spread investment risk to maintain it within acceptable limits. As a corollary, diversification is not mandated when it is considered imprudent to diversify. This duty should also not be misconstrued as a mandate to over-diversify or broadly hold all assets in a selected performance benchmark;

[7] The listed investor fiduciary duties and responsibilities may not apply fully in all jurisdictions and might be identified differently under local law. This high-level summary was compiled with assistance of legal counsel from numerous resources, including the Restatement (3rd) of Trusts: Prudent Investor Rule § 227 (1992) and Restatement (Second) of Trusts: Impartiality § 183 (1995); UK Law Commission: Fiduciary Duties of Investment Intermediaries (2014) at http://www.lawcom.gov.uk/app/uploads/2015/03/lc350_fiduciary_duties.pdf; Sullivan, Martindale, Feller and Bordon, Fiduciary Duty in the 21st Century, (September 2015) at http://www.unepfi.org/fileadmin/documents/fiduciary_duty_21st_century.pdf; High Legal Expert Group, on Sustainable Finance, Financing a Sustainable European Economy (February 2018) at https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf; Waitzer and Sarro, "The Public Fiduciary: Emerging Themes in Canadian Fiduciary Law for Pension Trustees" (2013) at http://digitalcommons.osgoode.yorku.ca/clpe/271/; Johnson, Introduction to Institutional Investor Fiduciary Duties, International Institute for Sustainable Development (February 2014), at https://www.iisd.org/library/introduction-institutional-investor-fiduciary-duties; Employee Retirement Income Security Act, 29 U.S. Code § 1104 - Fiduciary Duties, at https://www.law.cornell.edu/uscode/text/29/1104; and Gary, Best Interests in the Long Term: Fiduciary Duties and ESG Integration (February 2018) at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3149856.

> *"Asset owners are exposed to financial markets generally and so are unlikely to benefit over the long run from investment strategies which produce returns by generating systemic risks that jeopardise the efficient functioning of a particular market or markets more generally. Asset owners thus have an interest in ensuring that their fund managers help to foster well-functioning markets and do not risk undermining them through their investment approach or actions." ICGN Model Mandate, Section 1.2.*

- Duty to Incur Only Reasonable Costs to Achieve Investment Objectives so that fund assets are not wasted on excessive or needless expenses. It is important to note that this duty is not framed as an obligation to always take the lowest cost option, as the primary focus should be on net performance after fees, while achieving a reasonable rate of return within an acceptable level of risk that meets investment objectives;

- Duty to Inform and Consult with clients, beneficiaries or fund participants to foster accountability and to earn their confidence. This includes an obligation both to educate clients, beneficiaries and other stakeholders on matters relating to the exercise of fiduciary duties and to listen to these constituencies regarding how to meet those obligations. It is fundamental that investor fiduciaries act to properly inform, confer with and report to their clients, in order to achieve accountability and ensure the fund is invested in a satisfactory manner according to clients' and beneficiaries' interests, as expressed in the statement of investment policy'.

- Duty to Comply with Governing Documents. While often not viewed as a fiduciary issue, this recognizes the duty to ensure that all contractual, statutory and other legal obligations are sufficiently met to minimize the threat of any legal challenges and related expenses. ICGN encourages investor fiduciaries to ensure their Governing Documents are fit for purpose and to further commit to standards reflected in country stewardship codes and global principles.

Evolving Nature of Fiduciary Duty

It is important for investor fiduciaries to recognise that the application of fiduciary duty principles is a dynamic process. While fundamental fiduciary principles are relatively stable, their interpretation and implementation change as circumstances, knowledge and societal norms for reasonable behavior evolve.

As fiduciary duty is principles-based and process-oriented, rather than prescriptive, it may be applied differently by different entities. Varying fund circumstances (such as legal constraints, funding status, societal norms, risk tolerance, participant base and payout obligations) may influence fiduciary decisions. Even when a similar fiduciary approach is used, the ensuing strategy, decisions and end results may vary.

Governance responsibilities for Investor Fiduciaries

Asset owners should *undertake close scrutiny* of their model of fund *governance* rather than simply focus on how they *implement* their fiduciary duty across the investment chain. Navigating the asset owner and asset manager relationship appropriately to maintain healthy, two-way communication between informed parties is a core governance responsibility for investor fiduciaries. Asset owners are investor fiduciaries, and as such do not discharge their fiduciary obligations simply by hiring an investment manager. Asset owners may *delegate investment tasks* to investment managers, who themselves have a fiduciary duty to their client, but fiduciary duty itself is a core governance concept that cannot be delegated. A complicating factor is that the investment chain includes intermediaries who may not owe any fiduciary duty to the asset owner.

Stewardship expectations should be clearly articulated in the written mandate between asset owners and asset managers. Periodic evaluation of these terms as set out in the asset manager/asset owner agreements contributes to clarity of expectations and promotes mutual understanding between parties. ICGN's Model Mandate provides a framework and accompanying language to express these expectations (see also Part V)[8].

Asset owners should ensure they are appropriately informed and fully understand the implications of their instructions as set out in their statement of investment policies, such as asset allocation, market exposures, investment exclusions and other related investment parameters. These instructions then influence the investment universe, risk-adjusted returns and social impact, including systemic risk impacts. It is furthermore vital that asset owners recognize their accountability to fund beneficiaries. A investor fiduciary cannot act in the best interests of the client or beneficiary without informing the client or beneficiary of the risk-return implications of any investment strategy, and should consult with them periodically for client or beneficiary input. Thus, accountability is actually two-way: the investor fiduciary must report to the client/beneficiary and the client/beneficiary must recognise that any investment parameters they choose may impact investment risk and return.

Investor fiduciaries must consider whether fund assets are invested over an appropriate length of time, to meet current and future liabilities, are appropriately diversified and adequately consider ESG factors. Investor fiduciaries should also consider whether investment strategies are aligned with mitigation of systemic risk, and whether they are conducting appropriate stakeholder relations to inspire client/beneficiary confidence. They should aim to proactively inform and educate client beneficiaries of investment trends, risks and opportunities.

Investor fiduciaries exist to serve the best interests of their clients or beneficiaries. As such, the model of fund governance should clearly take the interests and expectations of clients and beneficiaries into account, and the fiduciary should understand how it is accountable for decisions it takes. Without such a model in place, it is quite possible for investor fiduciaries to satisfy narrow legal constructs of fiduciary duty while breaching the principle of trust between the fiduciary and the client/beneficiary. ICGN principles and policy statements may provide important guidance for investor fiduciaries on prevailing and leading practices that can help them effectively fulfill their obligations.

Part II - *Systemic Risk and Financial Market Stability*

A key responsibility for institutional investors with liabilities that are paid out and can extend over decades is the creation of long term, sustainable value. The Brundtland Report defines "sustainable development" as development that meets the needs of the present without compromising the ability of future generations to meet their own needs.[9] The fiduciary duty of

[8] International Corporate Governance Network, ICGN Model Mandate Initiative: Model contract terms between asset owners and their fund managers, 2012.

[9] Gru Brundtland et al. Our Common Future, 21 May 1987 World Commission on Environment and Development.

impartiality requires that investor fiduciaries with long-term obligations apply similar inter-generational risk management fairness standards.

The nature of systemic risk is that it builds over time, is interactive and synergistic and, once in play, is difficult to control. Systemic risk drivers tend to be cumulative and/or interdependent, resulting in far-reaching impacts, shocks, or even system- wide failure such as the global financial crisis in 2008. However, systemic risks can also affect investment returns more slowly, eroding economic performance over time in ways less obvious to market-relative benchmarks, for example, in the case of excessive income inequality.

Some of the more significant systemic threats facing the stability of the global financial system include: macro-economic risk (including market and credit risk, political, legal and regulatory factors); environmental risk (including climate change, water scarcity or pollution); social risk (including human rights, income inequality or populism), governance risk (including, expropriation of control and corporate culture); as well as technological risks (including artificial intelligence and cyber-security). Many of these risks feature prominently in assessments by entities such as World Economic Forum, World Bank, European Central Bank, Financial Stability Board (FSB) and CFA Institute, and are considered by investor fiduciaries in their respective risk assessments. Institutional investors are also increasingly reporting on their progress in meeting the United Nations' Sustainable Development Goals, a framework of 17 global goals which address societal risks such as poverty alleviation, gender equality, protection of fragile ecosystems, and encouraging sustainable infrastructure.[10]

Systemic risks present the classic "tragedy of the commons" dilemma. On the one hand, they may be treated as immaterial by many investors with short-term horizons and market-relative benchmarks. On the other hand, they can go unaddressed by long-horizon investors who assume they will be protected through broadly diversified market exposure and the regulatory environment of the day in which political factors are less of a consideration. The ultimate costs of systemic risks are, by definition, undiversifiable and borne by all market participants, as well as by society more broadly. Ensuring that their fund's investment strategy is protected against systemic risk is a concern for investor fiduciaries.

The production of investment returns to meet fund liability obligations, within a prudent level of risk, is the core obligation of investor fiduciaries, and it follows that consideration of systemic risk is also embedded in fiduciary duty. Investor fiduciaries, therefore should take both a fact-based and a longer term holistic view toward balancing how their investment practices affect the short- and long-term interests of the beneficiaries whom they are obligated to serve. Over the long-term, unsustainable investment practices that carry material systemic risks or impose negative externalities on society may have adverse financial consequences for beneficiaries.

> *"Particularly for pension funds and insurance companies funding annuities, the perspective of institutional investors is typically long-term. Both institutional investors and their beneficiaries therefore have a strong interest in ensuring that investee companies are successful and sustainable over time. This has broader systemic implications in terms of promoting healthy capital markets and economic development." ICGN Global Stewardship Principles, Section 3.*

Aligning actions to mitigate any potential effects from systemic risk may be considered part of fiduciary duty. The investor fiduciary should attempt to reconcile considerations of

[10] Information on the UN Sustainable Development Goals and related resources is available on the UN Development Programme website at http://www.undp.org/content/undp/en/home/sustainable-development-goals.html.

systemic economic, social and financial stability across the total fund with risk/return objectives and input from various stakeholders' points of view as follows:

- The vast majority of systemic investment risks fit into the political, environmental, social, technological, economic and legal (PESTEL) framework for organizational risk management and planning.[11] They include risks such as bribery and corruption, biodiversity loss, income inequality, human rights abuses, cyber-security, technological risks and weak rule of law. Investor fiduciaries should consider the interdependent nature of these risk categories, especially considering the impact of globalization resulting in further compounding of systemic risk exposures over time.

- Climate change has emerged as one of the most pressing, 'higher order' systemic financial risks considered by the investment community to date. Related investment risk considerations include: 1) physical weather-related impacts, resulting in property damage, insurance write-downs and interruptions of global business operations; 2) regulatory uncertainty across markets, with respect to countries' efforts to curb carbon emissions and various tax incentives; and 3) increased liability, with resultant reputational risks. Accordingly, investor fiduciaries should be aware of the implications that climate change has for asset class risk- for example, for real assets such as real estate and infrastructure, as well as for commodity risk exposures, industry risk exposures, operational risk, country risk exposures, asset life projections, stranded asset risk and heightened volatility of expected returns. The FSB Task Force on Climate Related Disclosure recommends that companies and investors alike disclose how they govern climate risk, their carbon emissions, emissions intensity, and their metrics and targets to decrease emissions over time.[12]

- Increasingly complex, interdependent global supply chains may be compromised by various problems, whether emanating from climate-related issues, labour-related issues, or political or regulatory issues, leading to business delays, reduced revenues, higher costs, dissatisfied customers, legal issues, issues of environmental degradation and even human rights abuses - all of which can have financial risk and return implications for long-term investors.

- Investor fiduciaries should seek to promote and demonstrate transparency by broadly disclosing their own governance processes. This includes the identification and management of systemic risk factors, such as including a description of how investors assess climate resiliency across portfolios, how they benchmark companies' environmental and social performance across sectors, and the impact of their own corporate culture on how they manage ESG risks/opportunities. A notable example of this is the requirement under French law, Article 173, for asset owners to publicly report on their carbon risks and climate policies.

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[11] This framework was first coined as 'PEST' by Harvard professor Francis J. Aguilar in "Scanning the business environment," New York MacMillan, 1967.

[12] Final Report, Recommendations of the Task Force on Climate-related Financial Disclosures, 15 June 2017; https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-TCFD-Report-062817.pdf.

- Investor fiduciaries should develop a governance framework to oversee management of systemic risk at the highest level and create a strategic plan that deals with systemic risks. This could include markers to identify early warning signals for systemic risk factors, such as over-leverage, excessive myopia, concentration of market liabilities, dysfunctional ESG practices and other potential sources of market contagion.

> *"Investors should recognise that a primary responsibility is to preserve and enhance value which is aligned in the interest of beneficiaries or clients over an appropriate time horizon, which in most cases requires a long-term perspective." Global Stewardship Principles, Section 1.1.*

Part III - *Appropriate Time Horizons*

Investor fiduciaries may have to balance potentially competing interests across different beneficiary groups, particularly when managing assets to cover long-term liabilities with different maturities. This includes balancing any conflicting investment strategy interests for “young” and “old” beneficiaries (e.g., generation of current income versus future capital growth) and invokes the concept of intergenerational equity. Fiduciaries with obligations to different generations should seek to fairly balance cross-generational wealth maximisation and the potential transfer of risks between generations. By their very nature, certain institutional investors (e.g. pension funds and insurers) are more likely to have a long-term approach for their investments and this is also reflected in applicable (prudential) regulations. A primary obligation of investor fiduciaries with long-term liabilities is to align investment practices with creation of long-term, sustainable value, while minimizing risks that could impact future returns.

> *"Positive portfolio and systemic effects of ESG factors are also relevant to the design of investment manager mandates. For example, knock-on effects of better company executive remuneration plans or enforcement of integrity standards for company behaviour or financial reporting can influence long-term, risk-adjusted returns at the asset, portfolio and financial system levels." ICGN Model Mandate, Section 1.0.*

Fiduciaries should also consider the unintended consequences of short-termism and its impact on how systemic, environmental, financial and social risks (see Part II and IV) are identified, understood and integrated in the investment process.

There are two misalignments at the heart of the sustainability challenge: one concerns the appropriate time horizon; the other concerns the appropriate conception of risk. Certain risks can be considered as more relevant (i.e. more likely to materialise) over the long term. The double compression of time and risk can drive a mismatch of investment objectives. Fiduciaries should clearly understand and manage the trade-offs between short-term value enhancement and long-term economic prosperity. A focus only on short term performance may result in unintended consequences which can undermine future performance or later emerge as material liabilities to the company or to society.

Institutional investors invest across multiple investment horizons, consistent with their investment objectives, policies, and short- and long-term fund liabilities. However, even investors with shorter term investment horizons can benefit from improving the longer term prospects for portfolio companies, which leads to more sustainable business plans and future cash flows and higher current valuations.

In order to mitigate the risk of short-termism this Guidance recommends:

- Investor fiduciaries with long-term liabilities should adopt investment and risk management policies and practices that promote long-term wealth creation consistent with their financial obligations to ensure long-term sustainable returns and they should consider inclusion of investor and corporate short-termism as risks to be addressed in policies and practices;

- Investor fiduciaries should consider identification and engagement with portfolio companies whose business strategies do not extend through their longest business cycle horizons, and whose activities or business models are more likely to be subject to structural changes or challenges in the longer term; and

- Investment strategies of long-term investor fiduciaries should include views on managing potential conflicts between short-term investing and engagement activities and practices that serve the long-term goals of investors with long-horizon interests.

The risk of a mismatch between the time horizons used for investments and long-term interests of ultimate beneficiaries increases when the management of assets is delegated to third parties. Contracts with third parties entrusted with the management of fund assets are typically short term, subject to extension or renewal. The award of (variable) compensation paid to managers can also be subject to short-term return on investments. This may create too many incentives for asset managers to focus on short-term performance. When delegating certain tasks, investor fiduciaries must act to preserve the interests of the ultimate beneficiaries. Investor fiduciaries with long term investment objectives or constraints should ensure that these are (also) properly reflected in the mandates of their asset managers: long term investment objectives and performance should be properly rewarded and should be relied upon when evaluating a possible extension or renewal of the asset management contract.

Part IV – *Environmental, Social and Governance (ESG) materiality*

> *"The term ESG factor is used [in the ICGN Model Mandate] to mean material and relevant investment risks and opportunities for asset owners with long-term investment horizons. They may have a significant (albeit often difficult to quantify) financial impact over the investment life of the asset owner – though often requiring an intervention to internalise external costs or some other regulatory change before those costs are triggered – and clients are increasingly seeking to build them into the risk management processes and investment decision-making of their managers." ICGN Model Mandate, Section 1.0.*

Historically, concepts of fiduciary duty have focused on the maximisation of investment returns without due consideration of environmental, social and governance (ESG) performance. However, expectations of investors have changed over time. The seminal Freshfields Report (2005) declared it to be an abrogation of fiduciary duty should investor fiduciaries fail to take relevant ESG considerations into account. PRI's 2015 report on fiduciary duty in the 21st Century built further from this, making the point that not considering long-term investment value drivers in investment practices is a failure of fiduciary duty. Moreover, the internet and social media have served to heighten public awareness of corporate malfeasance, in turn building public demand for responsible investment. The CFA Institute now includes ESG training in its programming, including ESG risk exposure analysis, resulting implications for valuations, and positive and negative screening. Client statements of investment policy and goals (SIPs) may feature specific clauses related to responsible investment and management of ESG factors. ICGN's own Global Stewardship Principles identify the promotion of long-term value creation and ESG integration as one of its seven overarching principles and has been delivering training courses on the subject since 2012.

ESG performance is increasingly viewed as material to investment risk and return, particularly for long-term investors. The list of ESG related risks and opportunities traditionally deemed 'extra-financial' is growing and is now viewed as mainstream, with potential financial impacts. These include environmental factors such as a company's commitment to decreasing emissions or its incorporation of eco-efficiencies, social factors such as the company's record on human rights, product safety and worker safety; it also includes governance factors such as board gender diversity or executive compensation linked to performance. Some ESG risks are considered more material to certain industry sectors. Organisations such as the International Integrated Reporting Council, The Sustainable Accounting Standards Board, the Global Reporting Initiative and other members of the Corporate Reporting Dialogue[13] are focused on improving corporate disclosure to determine which ESG metrics are material by industry sector. Overarching ESG risks reach across portfolios include legal and regulatory risk, geopolitical risk and reputational risk, which in turn lead to additional risk layers and risk outcomes, such as potential stranded-asset risk and systemic risk. There are also related investment opportunities.

Calls for improved corporate and investor ESG disclosure are being driven by investors, policy makers, regulators and the general public. Investor fiduciaries are attempting to address this demand by hiring more ESG expertise and embedding consideration of ESG across the investment process. It is now recognised that many institutional investors are essentially 'universal owners' of the global economy as they steward a disproportionate share of global wealth, most of which is broadly invested in global markets for the long term. This recognition of the economic importance of investor fiduciaries has fostered several country investor stewardship codes that encourage consideration of ESG factors in investment decision-making, including consideration of systemic risk exposures.

A number of academic studies have helped to illustrate and document the business case for responsible investment and the integration of ESG factors in the investment process. In the event of a choice between investment options with similar return-on-investment characteristics, the option with the better ESG assessment generally provides the positive differentiator and a lower risk profile over the long term, in alignment with clients' preference for lower risk. Similarly, an ESG-tilted portfolio has been demonstrated to offer insurance-like protection, which may result in a higher credit rating and a lower cost of debt.[14]

[13] See Corporate Reporting Dialogue: http://corporatereportingdialogue.com

[14] Paul C. Godfrey, Craig B. Merril and Jared M. Hansen, The relationship between corporate social responsibility and shareholder value: an empirical test of the risk management hypothesis, Strategic Management Journal, Vol. 30, issue 4, April 2009, p. 425-445. See also: Ioannis Oikonomou, Chris Brooks and Stephen Pavelin, The Effects of Corporate Social Performance on the Cost of Corporate Debt and Credit Ratings, The Financial Review 2014.

Other examples include, a meta-study concluded in 2012 that the cost of capital is lower for companies with higher ESG scores. Consideration of key ESG metrics can reveal alpha, or abnormal returns, that are overlooked by traditional investing strategies. [15] For example, a 2013 research paper concludes that a statistically significant and positive relationship exists between certain corporate governance metrics and company valuation.[16] A 2015 aggregated meta-study that reviewed around 2200 empirical studies relating to ESG and corporate financial performance concludes that roughly 90% of studies find a non-negative relation between ESG and corporate financial performance. This meta-study concludes that the large majority of academic studies report positive findings, and also concludes that the positive ESG impact on corporate financial performance appears stable over time.[17] Overall, the building weight of academic research across a broad spectrum of ESG factors demonstrates the importance of ESG performance to shareholder value.[18]

This growing body of academic and statistical evidence reveals a compelling business case for incorporating analysis of ESG factors into investment decisions and for management of exposure to systemic risks. Improved awareness of various incidents, accidents and corporate malfeasance has contributed to increased demand for responsible investment and consideration of ESG factors amongst asset owners and their beneficiaries. It also reflects the global community's growing concern about issues such as climate change and global supply chain issues involving human rights, industrial relations, occupational health and safety and environmentally harmful commercial practices. The lowering of the costs of accessing ESG data should have a possible effect on the use of ESG factors in investment decision-making.

Growing public and media attention to the potentially harmful long-term effects of corporate activity is attracting regulatory responses across the world. This, in turn, has stimulated investor demand for companies to provide better ESG disclosure, including how they mitigate environmental impacts, ensure worker safety and protect human rights, in recognition of a notional "social license to operate." During our era of near universal internet access, companies and their investors must deal with unprecedented reputational risk and associated pecuniary

[15] DB Climate Change Advisors, Sustainable Investing, Establishing Long-Term Value and Performance, June 2012, https://www.db.com/cr/en/docs/Sustainable_Investing_2012.pdf.

[16] Anita Anand (2013), The Value of Governance, Working Paper, The program on Ethics in Law and Business, University of Toronto, 2013.

[17] Gunnar Friede, Timo Busch and Alexander Bassen, ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies (October 22, 2015). Journal of Sustainable Finance & Investment, Volume 5, Issue 4, p. 210-233, 2015: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2699610

[18] There is much more research on this subject. For example, see: (i) Gordon L. Clark, Andreas Feiner, Michael Viehs, "From the Stockholder to the Stakeholder ", Oxford University and Arabeseque Partners, 2015: https://arabesque.com/research/From_the_stockholder_to_the_stakeholder_web.pdf; (ii) A 2017 State Street study demonstrates that ESG factors are regarded as financially material by most investors and that 92% of the investors surveyed want companies to identify and report on the material ESG issues they believe affect financial performance. It also observed that of 80% respondents agree or strongly agree there is a lack of standards around ESG integration; Robert G. Eccles and Mirtha D. Kastrapeli, "The Investing Enlightenment", State Street Corporation, 2017: https://arabesque.com/research/Final_The_Investing_Enlightenment.pdf, (iii) Another study by EY (2017) drew from 320 responses from buy-side senior decision makers. That study's findings are consistent with the State Street study, and concludes that investors see long-term benefits in companies with high ESG performance, and also noted that investors are demanding more from company ESG reports; Ernst and Young, "Is your nonfinancial performance revealing the true value of your business to investors?", Institutional Investor, 2017: http://www.ey.com/Publication/vwLUAssets/EY_-_Nonfinancial_performance_may_influence_investors/$FILE/ey-nonfinancial-performance-may-influence-investors.pdf

penalties, as well as increased regulation and attendant compliance costs. Companies may choose to respond to greater public focus on their corporate culture by, for example, offering reassurance and insights as to how they are managing related ESG factors and the expected impact on firm risk or performance.

Nevertheless, consistent and reliable data on ESG and systemic factors still lags investor demand. Investor fiduciaries should take account of their stewardship responsibilities, including ESG factors and systemic risk exposures, in development and implementation of investment and risk management policies. Formation of investment objectives and policies around materiality of these issues is a good place to start. Considerations outlined elsewhere in this Guidance regarding delegation of responsibility, oversight of service providers, and use of appropriate investment time horizons, are particularly relevant when it comes to stewardship and ESG integration. Asset owners should ensure that they consider inclusion of responsible investment and consideration of ESG in their statement of policy and procedures/goals, to be reviewed and updated regularly.

Policies and practices to be considered by asset owners build from ICGN's Global Stewardship Principles and should include:

- Ensuring that their investment managers, advisors, consultants and professional staff are fully competent and trained to take ESG into account across the investment decision making and reporting process. The CEO and CIO of the investor fiduciary should provide an assurance that ESG is adequately reflected in the internal processes;

- Development and use of bespoke proxy voting guidelines and corporate governance principles to adequately manage shareholder rights. Proxies are valuable client/beneficiary assets. The investor fiduciary should take care to ensure proxies are voted in the interests of those clients/beneficiaries and that shareholder voice is appropriately exercised;

- Priorities for company engagements and expectations for reactive, proactive and ongoing ESG company engagements;

- Collaboration with like-minded investors on company engagement initiatives to improve effectiveness, when appropriate;

- Incorporation of ESG factors, engagement results, and systemic risk considerations in the strategic plans, guidelines, performance metrics and reporting protocols across all asset classes (including corporate debt), as relevant;

- Active monitoring and evaluation of manager implementation of ESG and systemic risk management strategies;

- Reporting to beneficiaries and stakeholders on investment objectives and policies and their implementation, including on stewardship and ESG integration matters;

- Including the fund's performance on ESG factors into the compensation plan for investment staff. This could include feedback from client satisfaction surveys on the fund's management and integration of ESG principles.

Part V - *Fiduciary Duties in the Investment Chain*

Determination of who is defined as a fiduciary and under what circumstances is essentially a local law issue. However, fiduciary standards and ICGN principles provide direction for institutional investor leaders who seek to follow governance practices that are aligned with fiduciary principles in performing their duties, including their interactions with parties to whom certain tasks have been delegated with respect to the management of fiduciary assets.

Investor fiduciaries are seldom able to perform all of the tasks relating to asset management without relying on outside service providers. The investment service provider chain has grown longer over the past several decades, resulting in greater dispersion of the relationship between various parties involved. Fiduciaries may delegate certain tasks to third parties. However, no matter how complex the investment chain, ultimate fiduciary responsibility cannot be delegated from the investor fiduciary to a contracted third party, nor is there ever an acceptable level of ‘dilution’ of fiduciary duty arising from delegation to third parties.

Investor fiduciaries may be held accountable by fund beneficiaries, even when they choose to hire external managers and service providers to manage a portion of fund assets. This may occur in situations where a fiduciary does not possess the skills, market presence, expertise, resources or capacity to perform a desired task; however, the fiduciary responsibility for the selection, instruction and oversight of any third-party delegates (outside investment advisors, managers, consultants and other service providers) remains with the investor fiduciary. It remains a critical fiduciary function.

Investor fiduciaries should be attentive to aligning beneficiaries' interests with the interests of any third-party agents given authority to control a portion of fund assets. Accordingly, when hiring external third parties, the investment fiduciary should address pertinent issues during the selection process, incorporate these in the investment management agreements, and subject them to ongoing monitoring and reporting protocols.

In their selection processes for competent third party external managers the investor fiduciary should consider whether:

- The third-party managers under consideration can be held to the same standards as the asset owner/manager, whether via operation of the law or by contract. The duties owed to beneficiaries should not be diluted or diminished by delegation. In some instances, beneficiary interests might need to be explicitly identified when a selected provider is not otherwise cognizant of them;

- Due establishment of investment and risk management policies and processes include objectives with respect to time horizons, risk tolerances, stewardship responsibilities and ESG considerations, including in proxy voting and in company engagements, and how responsible investment activities will be reported to the investment fiduciary. Metrics used for monitoring investment portfolios should seek to balance short- and long-term performance indicators and include systemic risk, stewardship and ESG measures. Investor fiduciaries should encourage third-party managers to pay attention to these aspects. For investors with long-term liabilities, oversight should be focused accordingly, without overemphasizing short-term results that are immaterial to meeting obligations (see Part III of this Guidance);

- Decisions requiring approval or meriting notification to the investor fiduciary are appropriately specified, including circumstances allowing a revocation of the delegation.

"Asset owners are increasingly considering how they can more fully align the interests of their fund managers with their own obligations to beneficiaries and participants." ICGN Model Mandate, Preamble.

In addition, in its monitoring and evaluation processes the investor fiduciary should consider:

- Whether sufficient attention has been given to emerging trends regarding the potential imposition of regulatory standards across the investment service provider chain (e.g., proxy advisories, ratings agencies, carbon foot-printing services);

- Whether it has sufficient transparency processes to command a clear view of all parties involved in the investment chain. The delegation and sub-delegation of investment or management tasks should not reduce the flow of material information to the investment fiduciary or compromise its ability to exercise risk management, monitoring and investment responsibilities;

- Whether consistent provisions have been incorporated into service provider selection processes, contracts, guidelines and reporting protocols throughout the service provider chain, with attention given to authorised sub-delegations and investment counterparties. Asset owners should seek to avoid any breaks in the chain of fiduciary responsibility and stewardship;

- Compensation and remuneration paid to third parties, contracted or employed by the investment fiduciary, in charge of the investment and management of fiduciary assets should be aligned with beneficiaries' interests. They should include appropriate incentives for the services providers to act in accordance with the principles and objectives set by the investment fiduciary, including with regard to ESG and stewardship matters;

- Consideration should be given to whether a fiduciary can avoid contracting with third parties that seek to avoid an appropriate level of financial responsibility for their services;

Investor fiduciaries should retain full oversight of situations where different service providers take conflicting actions or decisions regarding management of the same assets. To the extent practicable, investor fiduciaries should prioritise reporting, disclosure, communication and coordination throughout the investment service provider chain in order to identify any situations where different managers or advisors may end up working at cross purposes to the detriment of the overall fund, and subsequently direct actions to most consistently benefit the fund.

Part VI - *Reporting and accountability*

Fiduciary relationships involve a contract that requires trust between beneficiaries and the agents who control management of their assets and represent their interests. Effective two-way communication is essential to maintaining trust and informing the fiduciary's efforts to serve beneficiaries' interests. Accordingly, an investment fiduciary has a duty to inform and regularly engage with its beneficiaries/clients. Most investor fiduciaries are already subject to regulatory or contractual reporting obligations designed to keep beneficiaries and other stakeholders informed about matters that are relevant to performance of obligations.

The scope of reporting obligations or guidelines has increased over time. Subject to mandatory reporting obligations which may be more specific or have a wider scope, investor fiduciaries should regularly report how their investment principles, objectives and activities address systemic risk and contribute to financial market stability (Part II) and how they take into consideration the appropriate time horizons (Part III) as well as ESG factors (Part IV). Investor fiduciaries should also explain and justify how actual investments of assets (asset allocation, portfolio companies, etc.) and related stewardship activities are consistent with the stated investment principles and objectives. Many institutional investors are beginning to report on the UN Sustainable Development Goals, which were adopted by the UN as a template to address salient global issues, with implications for policy makers, companies and investors.

Delegation to third parties should be addressed. These agents must be subject to mutually agreed upon reporting obligations, consistent with the objectives of the investor fiduciary. The investor fiduciary should further require assurance of the quality of the reporting, which can be used in their communications with beneficiaries, together with a description of how the delegation of tasks to third parties is consistent with the interests of beneficiaries (Part V).

Plan for Stakeholder Communications.

- Robust stakeholder relations should be a priority for institutional investors. From a practical perspective, an effective stakeholder communications plan can avoid unnecessary problems and reduce liability exposure. Information and transparency about how investor fiduciaries discharge their duties serves to inform clients and helps them to hold investor fiduciaries to account.

- Investor fiduciaries should adopt and maintain the appropriate internal governance structures, policies and protocols to facilitate the process of seeking and receiving regular input and feedback from client/beneficiaries and, where possible, address and seek to align various client/beneficiary preferences in the investment process.

- Investor fiduciaries should facilitate an ongoing dialogue with their clients and/or beneficiaries. Clients/beneficiaries should be given the opportunity to express their opinion about investment objectives and principles, including on issues addressed in this Guidance. Investor fiduciaries should also take the initiative to consult with their beneficiaries whenever they want to review those objectives or principles.

- All clients, beneficiaries and key stakeholders should be treated equitably, including in the situation of a multi-client or multi-stakeholder relationship.

> *"Investors should publicly disclose their stewardship policies and activities and report to beneficiaries or clients on how they have been implemented so as to be fully accountable for the effective delivery of their duties." Principle 7 ICGN Global Stewardship Principles.*

In approaching reporting and stakeholder communications obligations, investor fiduciaries should review best practices of peers and develop their own stakeholder relations plan aimed at preserving a high level of trust while meeting reporting requirements. Investor fiduciaries should also explore ESG and systemic factors reporting across portfolios and encourage investee companies to integrate ESG reporting into their financial reporting.

Serving as an investor fiduciary is a demanding role that imposes high standards of conduct and requires close attention to evolving industry practices. Robust communication protocols lie at the heart of managing the fiduciary-investment manager relationship. The investor fiduciary has a duty to inform and educate its client beneficiaries without unduly influencing them; while it is important that the asset owner remains sufficiently informed to understand the investment consequences of its investment policies for asset allocation, risk tolerances and exclusions.

The fact that the investment chain has become increasingly complex does not ‘water down’ fiduciary duty responsibility or its core underpinning principles of trust and stewardship. The investment manager who manages multiple external manager and fund relationships must work harder to ensure that various investment strategies align with its overarching fiduciary obligation principles.

While twentieth century fiduciary duty concepts focused on risk-adjusted return in investment and near-term financial indicators, today there is a widespread acknowledgement that ESG factors contribute to financial risk and performance as well as systemic risk. Investor fiduciaries must focus on aligning their governance and practices with beneficiary interests in respect of these factors. The ICGN Model Mandate provides a summary of how to incorporate twenty first century understanding of fiduciary principles into the governance practices of institutional investor fiduciaries.

“Key areas of focus for asset owners which are seeking to align the activities of their fund managers more closely with the long-term interests of their beneficiaries are:

- *ensuring that the timescales over which investment risk and opportunity are considered match those of the client;*
- *setting out an appropriate internal risk management framework so that the risks which matter for clients are managed effectively;*
- *effectively integrating relevant environmental, social and governance factors into investment decision-making and ongoing management;*
- *aligning interests effectively through fees, pay structures and culture;*
- *where engagement is delegated to the fund manager, ensuring, adherence to the highest standards of stewardship;*
- *ensuring commission processes and payments which reward appropriate research;*
- *ensuring that portfolio turnover is appropriate to the mandate, in line with expectations and managed effectively; and*
- *providing appropriate transparency such that clients can gain confidence about all these issues." [ICGN Model Mandate, Preamble]*

ICGN Guidance statements provide a resource for investor fiduciaries, investment managers and interested parties. They provide insights into leading governance practices that are aligned with fiduciary duties and can help investor fiduciaries fulfill obligations to the beneficiaries and stakeholders who rely upon them. A list of ICGN Guidance statements in provided in the attached Appendix.

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APPENDIX: ICGN Guidance (member approved)

- Global Governance Principles (2017)
- Global Stewardship Principles (2016)
- Anti-Corruption Practices (2015)
- Corporate Risk Oversight (2015)
- Diversity on Boards (2016)
- Executive Remuneration (2016)
- Integrated Business Reporting (2015)
- Gender Diversity on Boards (2013)
- Non-Executive Remuneration (2016)
- Political Lobbying and Donations (2017)
- Securities Lending Best Practice (2016)
- Model Mandate (2012)