**Fiduciary Duty is Not an Obstacle to Addressing ESG**

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**Introduction**

Outdated interpretations and limited understandings of materiality have led to the misconception that addressing environmental, social and governance (ESG) factors falls outside the scope of fiduciary duty. As a result, incompatibility with fiduciary duty has often been given as a reason by asset managers and advisers for not incorporating ESG factors into the investment decision-making process. A recent Principles for Responsible Investment report “Fiduciary Duty in the 21st Century,” published along with UNEPFI, UNEP Inquiry and the UN Global Compact, looked at fiduciary duty across eight markets--US, Canada, UK, Germany, Brazil, Australia, Japan and South Africa--and found that for asset owners, fiduciary duty is not an obstacle to action.

Fiduciary duties exist to ensure that those who manage money on behalf of others act in the interests of beneficiaries, rather than serving their own interests. Under the duty of loyalty, fiduciaries should act in good faith, should impartially balance the conflicting interests of different beneficiaries, should avoid conflicts of interest and should not act for the benefit of themselves or a third party. The duty of prudence calls on fiduciaries to act with due care, skill and diligence, investing as an ‘ordinary prudent person’ would do.

There are extensive in-depth legal, academic, and investor arguments for, rather than against, accounting for ESG factors in investment decisions. Key to these arguments, from an asset steward perspective, is the recognition of aligning liabilities with frameworks that prioritize long-term value creation and the likelihood of increasing materiality across a long-term horizon. Case law as well as fiduciary frameworks recognize the need to preserve assets to satisfy future, as well as present, claims and requires that trustees take impartial account of the interests of all beneficiaries.

A long-term investment horizon requires the consideration of factors that might influence investment performance and strategies over time. The lead-up to the 2008 financial crisis, for instance, demonstrated how a focus on quarterly gains, or “quarterly capitalism,” can drive behaviors that may have immediate benefits but endanger performance over a long-term investment horizon.

Fiduciary practices that fail to address key material factors over a relevant time horizon can fall short of maximizing a portfolio’s risk and return profile. As recommended by the CFA Institute, trustees should “consider all relevant risk and value factors deemed appropriate when designing the scheme’s investment strategy.
In addition to typical financial measures, these factors may include environmental, social, and corporate governance issues.”\(^1\)

Past changes in interpretation reflect the dynamic nature of fiduciary duty in the U.S. As the landscape for investment changes, so too does the notion of fiduciary duty. The processes and approaches used to guide investment decisions have evolved over time in response to changes in the generally accepted understanding of market behavior.\(^2\)

We are again at an inflection point. As the evidence and rationale behind addressing material and business related impacts of ESG factors in the investment process further develops and is increasingly accepted, so does our understanding of these factors through a fiduciary lens.

**Challenges**

Current fiduciary obstacles have centered around the misconceptions that 1) addressing ESG factors is prohibited under ERISA guidance, 2) addressing ESG must limit the investable universe and/or negatively impact performance. Furthermore, a lack of knowledge on ESG issues persists amongst investment consultants and legal advisers.

1) **Lower general acceptance of the financial relevance of ESG in the US**

Commonly held views about ESG in the US are often a barrier to implementation. There is often a misunderstanding that addressing ESG issues must negatively affect investment performance, and that responsible investment is the same as negative screening. However, incorporating ESG factors and engaging in shareholder activism can improve long-term performance. For example, both CalPERS and Florida SBA have quantified the value creation of their respective funds’ active ownership activities.

2) **Addressing ESG under ERISA**

The Department of Labor’s (DOL) 2008 guidance on the Employee Retirement Income Security Act of 1974 (ERISA), which was recently supplemented with a new Interpretive Bulletin,\(^3\) raised concerns regarding if and how funds can address ESG issues in the investment process. ERISA oversees corporate pension plans, but its influence has gone much further because many public funds follow its provisions, in particular in relation to the standards of care that are expected of fiduciaries.

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\(^1\) CFA Institute, Code of Conduct for Members of a Pension Scheme Governing Body, 2008.


\(^3\) DOL Interpretive Bulletin 2015-01 advises that “fiduciaries should appropriately consider factors that potentially influence risk and return” and that “environmental, social, and governance issues may have a direct relationship to the economic value of the plan’s investment.” The DOL continues, "In these instances, such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary’s primary analysis of the economic merits of competing investment choices."
Although there is no legal obstacle to considering ESG factors under ERISA, after the 2008 guidance, concerns arose regarding implementation under the duty of prudence. The DOL's new guidance now makes it clear that material ESG factors may be considered as part of a fiduciary's primary investment analysis. In addition, later this year PRI will publish guidance from two prominent legal firms, Morgan Lewis and Groom Law, to clarify how fiduciaries can address ESG factors within ERISA guidelines. Groom Law presents a prudent process for considering ESG criteria in investment and divestment decisions. Morgan Lewis’ contribution clarifies how duty of loyalty issues in DOL guidance on social investing and ETIs apply to fiduciaries incorporating ESG factors that affect long-term investment returns.

3) Agency chain and organizational barriers

Complex organizational relationships and cultural dynamics also create barriers to the advancing the integration of ESG factors in the investment process. The advice that has been given by consultants and advisers – in particular in the US – is often based on a very narrow interpretation of fiduciary duty as well as a lack of knowledge on ESG issues. One interviewee for our report noted: “they find it easier to say ‘no’ when asked about these issues.”

Moving Forward

In order to move toward a sustainable financial and economic system, “Fiduciary Duty in the 21st Century,” recommends that all of the players in the investment process take specific actions in order for ESG to be implemented on a truly global scale.

First, institutional investors need to ensure that their commitments to ESG integration are followed across the entire investment process. They also need to require companies to provide robust, credible and detailed accounts of their management of ESG issues, and of the financial significance of these issues, as well as engage policymakers on issues relevant to long-term performance.

Based on legal precedence, trustees can consider ESG factors in their investment decisions; however, demonstrating due diligence through documentation is essential. When evaluating whether an institutional investor has delivered on its fiduciary duties, courts will look at the process followed, rather than the outcomes achieved. In our research we found that courts ruled that trustees are within their fiduciary duty to make

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4 Interpretive Bulletin 2015-01 recognizes that the 2008 DOL advice created confusion and clarifies, "Fiduciaries need not treat commercially reasonable investments as inherently suspect or in need of special scrutiny merely because they take into consideration environmental, social, or other such factors. When a fiduciary prudently concludes that such an investment is justified based solely on the economic merits of the investment, there is no need to evaluate collateral goals as tie-breakers."
decisions based on ESG factors when they have documented their due-diligence processes.\textsuperscript{5}

Second, intermediaries (legal advisers, investment consultants, stock exchanges, brokers and data providers) need to analyze and take account of long-term value drivers, including ESG issues, in their investment practices and processes while also ensuring that ESG issues are an integral part of codes of professional ethics, and through raising market awareness of the investment case for ESG integration.

Finally, policymakers should further clarify that fiduciaries must take account of material ESG issues in their investment processes, their active ownership and voting activities, and be transparent on all aspects of ESG integration and investment practice.

\textit{Conclusion}

Given the growing domestic and global investment activities integrating ESG issues, fiduciaries that address ESG meet the requisite under the duty of prudence to act with the same care, skill, and prudence exercised by their peers. Because of this, many countries have now introduced regulations and codes requiring institutional investors to take account of ESG issues in their investment decisions, to engage with companies in which they are invested on ESG issues, and to report on how they have implemented their commitments to responsible investment.

Recently, it seems almost every year there is an event that highlights the business and financial implications of ESG factors when there are short sighted management decisions or incentives at play – the Deepwater Horizon oil spill, the Rana Plaza collapse, and now Volkswagen emissions scandal. It is becoming clear that to fulfill their duties fiduciaries must ensure their risk universe covers the range of potentially material issues, including ESG factors, relevant to a long-term investment horizon.

\textsuperscript{5} In the case of Board of Trustees of Employee Retirement System of Baltimore v. City of Baltimore, the state’s highest appellate court ruling found that the city workers’ pension fund could follow an ordinance for South Africa divestment without the trustees failing their duty of loyalty and prudence. The court stated “a trustee’s duty is not necessarily to maximize the return on investments but rather to secure a ‘just’ or “reasonable” return while avoiding undue risk.” The importance of fiduciaries due diligence process and documentation is also illustrated in the case of Brock v. Walton, regarding below market rate loans to fund participants, the court stated, “the trustees examined loan rates charged by major commercial financial institutional in the area and determined that if they applied those rates they would have virtually no loan activity.” This statement is somewhat unclear, but leads one to believe that it was the due diligence process that allowed this loan to be considered legal under ERISA.