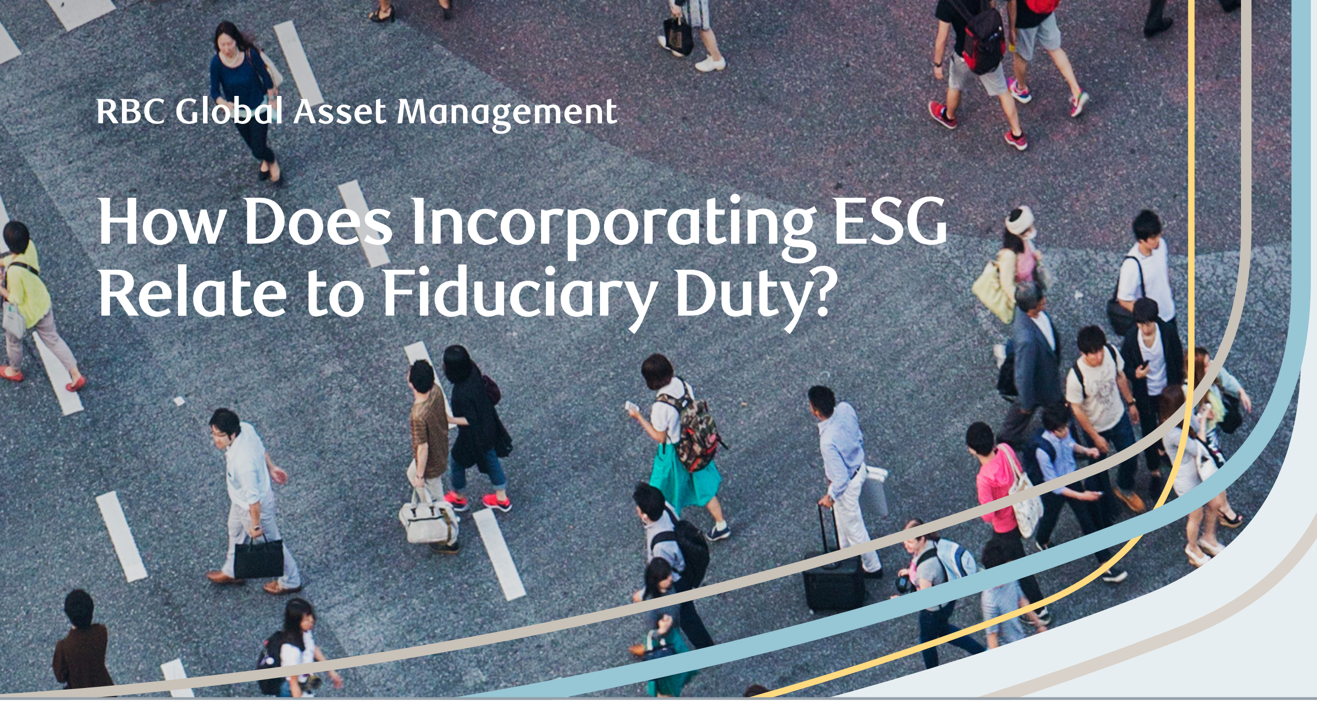
RBC Global Asset Management

How Does Incorporating ESG Relate to Fiduciary Duty?



This article is one of a series based on the results of the 2021 RBC Global Asset Management Responsible Investment Survey. The Survey, entitled '[ESG in a pandemic world](),' revealed meaningful insights on the considerations of environmental, social and governance (ESG) factors by global institutional investors.

What is a fiduciary? A fiduciary is an entity "to whom power or property is entrusted for the benefit of another."[1] Fiduciary duties include "a duty of confidentiality, a duty of no conflict, and a duty not to profit from one's position."

In our annual survey of attitudes towards responsible investment, institutional investors cited fiduciary duty as the top reason for incorporating ESG in their investment approach.

For the minority of respondents who said they do not use ESG principles in their investment approach, however, a plurality said it was because they do not believe ESG to be consistent with the fiduciary duty to maximize returns. The U.S. had the most adherents of this viewpoint, followed by Canada and Asia. This confusion as to whether fiduciary duty requires or forbids ESG is perhaps an outgrowth of recent changes in the investment and legal spheres.

At one time ESG factors were generally considered nonfinancial in their nature, so legal scholars wondered whether fiduciary duty might restrict fiduciaries from taking them into account. Some wondered, that is, whether fiduciary duty permits consideration of ESG factors. "Some institutional investors, whether asset owners or investment managers, have defined their fiduciary duties in narrow terms, arguing that they preclude consideration of Environmental, Social and Governance ('ESG') factors in investment processes."[2]

In 2005, the legal background began to change. That year, the United Nations Environment Programme's Finance Initiative (UNEP FI) commissioned a report known as the Freshfields report which set forth the principle that managers could consider ESG factors without violating fiduciary duty. That report looked at the laws in a number of the world's most advanced economies and came to the conclusion that "integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions."[3]

This report confirmed that ESG factors can be taken into account, and set the groundwork for the assessment of materiality. In the UK, the Law Commission in its 2014 report on Fiduciary Duties of Investment Intermediaries acknowledged this anxiety while seeking to lay it to rest: "We hope that we can finally remove any misconceptions on this issue: there is no impediment to trustees taking account of environmental, social or governance factors where they are, or may be, financially material."[4] While allowing fiduciaries to consider ESG factors, the report stops short of mandating this: "we do not think it is helpful to say that ESG or ethical factors must always be taken into account."

The UK is not alone in wrestling with these sorts of issues. A 2021 report by Freshfields, entitled "A Legal Framework for Impact," looks at the law in the United States and finds that "the current understanding, especially in the context of pension fund management, is that where an environmental, social or governance factor has material implications for the realization of an investor's financial investment objective, then the investor will be under a duty to take it into account appropriately in the way it seeks to discharge its duties to pursue that financial objective."[5]

In the U.S., two 2020 Labor Department (DOL) rules imperiled the consideration of ESG under the fiduciary duties required under ERISA, a law governing workplace retirement savings. The rules, which focused on the consideration of "pecuniary" and "non-pecuniary" factors when selecting investments, and on the role of proxy voting in fiduciary duty, were issued towards the end of the Trump administration and viewed as barriers to the consideration of ESG factors in investment and voting decisions. However, under the Biden administration in 2021, the DOL confirmed it would not move ahead with enforcement and ultimately proposed new, clarifying rules, promptly reversing course.

In Canada, as the Responsible Investment Association notes, "The evolution of fiduciary responsibility as it pertains to ESG issues led the Ontario government to amend the pension fund investment regulations in 2016, requiring pension funds to include in their statements of investment policies and procedures (SIPPs), information about whether, and if so, how ESG factors will be incorporated into their decision-making process."[6]

The Principles for Responsible Investment (PRI), a UN-supported network of investors promoting responsible investment, states that fiduciary duty mandates consideration of ESG factors, saying "the fiduciary duties of loyalty and prudence require the incorporation of ESG issues."[7] The PRI bases its position on three points: 1) ESG incorporation is an investment norm, 2) ESG issues are financially material, and 3) policy and regulatory frameworks are changing to require ESG incorporation. The PRI suggests that "Investors that fail to incorporate ESG issues are failing their fiduciary duties and are increasingly likely to be subject to legal challenge."

One can see that the legal discourse regarding ESG and fiduciary duty is rapidly evolving. But it's not just the legal discourse. The changes in legal opinion reflected above track similar changes in the investment community, where material ESG considerations are increasingly part of investment decision making.

At RBC Global Asset Management, all of our investment teams integrate material ESG considerations into their investment approaches. We believe that being an active, engaged and responsible owner empowers us to enhance the long-term, risk-adjusted performance of our portfolios and is part of our fiduciary duty. Our approach to responsible investment is anchored by the knowledge that our clients have entrusted us to help them secure a better financial future for themselves or for the beneficiaries of the funds they manage.

Learn more about our approach.

[1] Practical Law, Thomson Reuters, 2022 (Link)

[2] Sustainability and Fiduciary Duties in the UK, Oxford Faculty of Law, 2017 (Link)

[3] UNEP FI, A legal framework for the integration of environmental, social and governance issues into institutional investment, 2005 (Link)

[4] Fiduciary Duties of Investment Intermediaries, The Law Commission UK, 2014. (Link)

[5] A Legal Framework for Impact, Freshfields Bruckhaus Deringer, 2021 (Link)

[6] Fiduciary Duty Fact Sheet for Investors, RIA, 2019 (Link)

[7] Fiduciary Duty in the 21st Century, PRI, 2019 (Link)

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