Public Consultation on Changes to Clarify and Strengthen Trustees' Investment Duties

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Re: **Public Consultation on Changes to Clarify and Strengthen Trustees' Investment Duties**

Preventable Surprises, a UK nonprofit think tank devoted to preventing (or at least mitigating) foreseeable corporate and market implosions, supports the DWP's proposed law clarifications. However, we recommend several additional provisions to help overcome natural human behavioural biases that would be likely to interfere with realization of rational decision making processes which the DWP seeks to promote.

Modify Annual Reports to Better Encourage Participant-Aligned Fiduciary Conduct

We believe the proposed DWP law changes would improve investor fiduciaries' capacity to identify and avoid investment practices that are likely to do damage to the future financial, personal, societal and environmental well-being of fund participants. Nevertheless, annual reports in the proposal would more effectively align fiduciary behaviours with the interests of fund members if several "nudge" provisions were included that highlight desired goals. To ensure top level support within a fund for implementation of improved practices, the trustee board should be explicitly required to consider and approve disclosures on the following items.

1. An estimate of the average maturity (in years) of the fund's liabilities or the most prevalent investment time horizon of savers for their use of assets invested in the fund. The board should explain how that time horizon is reflected in the Investment Strategy Statement (ISS) and reflected in portfolio manager and investment advisor compensation schemes. Alternatively, the board should disclose if the time horizon of fund liabilities was not explicitly applied in development of the ISS or fund compensation schemes and explain why. The Kay Report, Bank of England and Law Commission have all lamented the widespread failure of trustees to ensure that time horizons of fund participants are matched by fund investment practices. For example, the Law Commission concluded, "The primary purpose of the investment power given to pension trustees is to secure the best realistic return over the long-term, given the need to control for risks."

2. At least the top five systemic or ESG risks associated with portfolio investment practices (in the aggregate) to which fund participants are exposed. The board should explain how the ISS, stewardship practices and portfolio incentive compensation scheme provisions

reflect those risks or disclose that they are not explicitly considered and explain why. Within the investment industry, it is well accepted - if not openly discussed - that there are many incentives of agents that work against attempting to address the systemic risks that are ultimately borne by end savers as members of society. Because systemic risks are everyone's problem, they are widely seen as nobody's responsibility (the insidious 'bystander apathy' and ‘tragedy of the commons’ phenomena). Hence this regulatory nudge is the minimum that is needed.

3. Conversely, at least the top three ESG or impact-related investment opportunities or themes identified as presenting the potential to generate market rate returns for fund investments over the appropriate time horizons. Systemic and ESG risks also present investment opportunities that are strongly aligned with participant interests. By nudging the trustee board to explain how the fund’s ISS and asset allocation practices address those opportunities, or explicitly disclose that ESG and impact investment opportunities have not been considered, annual reports would also focus on positively aligned capital allocation practices.

4. An explanation of any efforts undertaken to discern views of fund participants on systemic risk exposures and ethical investment preferences. This is a natural component of existing “Know Your Customer” requirements. Without an understanding of participant preferences, behavioural biases are likely to result in application of the personal preferences held by fiduciary agents, which may be inconsistent with those of the fund participant population.

A) The annual report should include an explanation of how the fund has sought out and developed an understanding of the investment preferences of fund participants. Today the “Know Your Customer" regulatory focus is on bribery and corruption. While these are systemically important concerns, we think they are an arbitrary subset of the real range of systemic risks and investment preferences of savers that should be understood and considered by fiduciaries. The new law could explicitly identify examples of primary systemic risks which should be covered as part of understanding the interests of customers. For example, Know Your Customer principles could prioritize fiduciary consideration of savers’ views and interests regarding climate change (one of the most important environmental systemic risks), income inequality (one of the most important social systemic risks) and corporate expenditures on political influence (one of the most important corporate governance systemic risks).

B) The report should also explain how those preferences relate to the risks and investment opportunities identified in items 2 and 3, above. Transparency about whether and in what ways participant views have been incorporated into investment practices should also be included in the annual report.

5. Investment and fiduciary training courses or classes attended by members of the board over the past year. Any relevant links to provisions of the ISS, stewardship practices and fund administration should be identified, as well as the training provider. Given the evolving nature of our understanding of systemic risks and materiality of ESG factors, education of trustees is a critical prerequisite to meeting 21st century fiduciary challenges.

Preventable Surprises sees these “nudge” annual report disclosures as essential to promoting fiduciary accountability. Furthermore they will encourage the application of a long-term oriented and holistic understanding of the fiduciary duty of loyalty to the interests of fund participants. We recognise that more detailed reporting standards might not be appropriate for small funds. However, the Government has acknowledged that systemic problems fostered by shared investment industry practices can generate huge costs over the long term for society and fund participants as members of society.

We commend the DWP's proposals and recommend expanding the proposed annual reporting content to provide behavioural nudges designed to encourage greater attention to alignment of the ISS' provisions with fund participant interests.

We also suggest that the DWP review a recent leading law review article on systemic risk and Modern Portfolio Theory that has been written by Professor James Hawley and Jon Lukomnik. It contains important practical context and advice supporting our recommendations and on achieving goals of the DWP initiative. That article, “The Long and Short of It: Are We Asking the Right Questions? Modern Portfolio Theory and Time Horizons” is available at: https://digitalcommons.law.seattleu.edu/cgi/viewcontent.cgi?article=2507&context=sulr.

We would be happy to meet with you to explain any of our proposals in greater detail if that would be helpful

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