Pension Scheme Investment: Is it Always Just About the Money? To What Extent Can or Should Trustees Take Account of Ethical or ESG Factors When Investing?

*Susie Daykin**

Introduction

Trustee investment powers and duties have recently been scrutinised by the Law Commission. One of the core questions addressed was whether the law allows, requires or prevents trustees from taking account of ethical or ESG[1] factors when investing pension scheme assets or whether traditional financial metrics should be the only relevant consideration. Is it always just about the money for trustees, or can or should it ever be about anything else?

After an extensive consultation, the Law Commission confirmed its views on these questions in its final report, 'Fiduciary Duties of Investment Intermediaries', issued in June 2014. The report summarises the Law Commission's views on the existing legal duties and obligations that apply to pension scheme trustees when making investment decisions and the factors that trustees can take into account when doing so. The key conclusions are distilled into a separate five-page guidance note for trustees, entitled, 'Is it always just about the money?'

This paper considers what is meant by ESG investment and how it is considered to be different from ethical investment, the relevant legal framework for investment, the conclusions of the Law Commission and some challenges and difficult issues for trustees in this area.

ESG and ethical investment: an introduction

What is ESG and why and how is it used in investment decision making?

ESG stands for 'environmental, social and governance'. An ESG investment approach is one where factors relating to environmental, social and governance issues are taken into account in the investment process. These might be integrated into the asset selection process or used to inform an investor's approach to stewardship activities (ie voting and engagement).[2]

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* Partner and Solicitor, Travers Smith LLP, London.

1 The term 'ESG' is explained below.

2 This paper only considers the use of ESG/ethical factors in investment selection decisions and does not cover issues relating to stewardship activities of trustees and the application of ESG/ethical factors in those activities.

What sort of factors might fall under the E, S and G headings? The following table gives some examples of ESG factors and their potential relevance to investment decisions. The table assumes the investments in question are stocks within an equity portfolio, in which case an ESG investor would assess listed companies against these factors as part of its stock selection decisions.

	What sort of factors might be considered?	**Relevance to company performance?**
Environmental	Energy consumption, resource management, pollution risks, approach to climate change	Relevant to a company's environmental liabilities, energy costs, adaptability to climate regulation/shocks
Social	Employee relations (eg pay, diversity), supply chain issues (eg use of child labour), community relations, CSR values, business ethics (eg tax schemes)	Relevant to a company's business reputation, customer loyalty, brand value, staff productivity
Governance	Executive compensation, shareholder relations, oversight, disclosure	Good governance correlates to good performance. Relevant to market confidence, stability of share price, protection from profit shocks

Why might investors take an ESG approach? There are a number of different reasons.

Long-term investment performance

ESG investors believe there is a positive correlation between ESG factors and long-term investment performance. The table above shows how ESG factors can be linked to issues relevant to the longer-term success (or not) of a company. A well-governed company might be expected to be more successful than a badly governed company. A company with low energy use might be more efficient and, therefore, profitable, than a company with very high energy costs. A company with strong employee values may enjoy greater productivity.

Investment risks

There are many risks to the long-term performance of a company and the returns generated for its shareholders. ESG factors are considered by some to provide a better set of criteria for assessing those risks. In particular, these factors are considered more likely to pick up the sort of low probability high impact events (so called 'black swans') that might be discounted-out by conventional metrics. A survey conducted by PwC in 2014[3] of investor motivations reported that for 73 per cent of investors taking an ESG approach, risk mitigation was the driving factor for doing so.

An example of how such factors might signpost risks to long-term investment performance is given by Jonathan Hilton writing in the *Evening Standard* about Tesco. He argued that if investment analysts had paid closer attention to factors such as Tesco's business

3 'Sustainability goes mainstream: insights into investor views' PWC (May 2014).

ethics, customer reputation, brand loyalty and supply chain issues, they might not have been so surprised by the overstatement of expected profits:

> 'There have long been things in the Tesco's behaviour and business model that did not seem sustainable, and were possibly even toxic ... the interesting thing about Tesco is not that its profits have collapsed but that they stayed as high as they did for so long.'[4]

Wider sustainability concerns

Some investors adopt ESG factors because they see these as important for supporting and promoting the sustainability and stability of economic, social and environmental systems more generally:

> 'Responsible investment is an approach to investment that explicitly acknowledges the relevance to the investor of environmental, social and governance (ESG) factors, and the long-term health and stability of the market as a whole. It recognises that the generation of long-term sustainable returns is dependent on stable, well-functioning and well-governed social, environmental and economic systems'.[5]

Different types of ESG investment approach

There are many different ways of using ESG factors within an investment approach. The European SRI Study published by Eurosif[6] in 2014 describes the following different types of strategies:

- ESG integration – this is where asset managers include ESG factors within investment decision-making processes based on research and analysis. This may be done on an informal basis (non-mandatory but where the information is available and may or may not be used by the investor or manager) or on a systemic basis where integration of ESG criteria is systemically used within the investment approach.
- Negative/positive screening – this strategy either excludes or includes companies or sectors from the 'investible universe' based on ESG considerations.
- Best in class – this approach uses ESG criteria to select the top percentage of companies within a sector based on ESG criteria, so it might also be described as form of positive screening.
- Sustainability themed – investors select investments based on specific themes such as climate change or energy efficiency. This may be because of a belief that the thematic investments (perhaps because of their importance to sustainability issues) as a sector will be likely to outperform the market over the investment period.
- Engagement and voting – this is where investors exercise stewardship (ie exercise the

4 'How City missed Tesco's fall from grace' by Anthony Hilton in the *Evening Standard*, 24 September 2014, considering the impact of customers, suppliers, community relations and reputation issues as indicators of the potential profit problems facing Tesco.

5 United Nations Principles for Responsible Investment 'Introducing Responsible Investment' (see http://www.unpri.org/introducing-responsible-investment/).

6 Eurosif describes itself in its 2014 European SRI Study as 'the leading Pan-European sustainable and responsible investment (SRI) membership organisation whose mission is to promote sustainability through European financial markets'.

rights and/or influence they can bring to bear as investors in relation to their investments) to promote ESG values, whether in formal voting or other investor engagement activities.

ESG investment: responsible or ethical?

'Responsible investment' is a term that is increasingly used to describe investment approaches based on ESG factors. This connection between responsible investment and ESG was cemented by the 'Principles of Responsible Investment' (PRI) initiative established by the United Nations in 2006.

The UN PRI consist of six principles of 'responsible investment' to which those involved in institutional investment (asset holders, fund managers, professional advisers) can subscribe. The principles are based around the importance of incorporating ESG issues into investment practices. The core belief and the six principles of UN PRI signatories are as follows:

> 'As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:
> 1. We will incorporate ESG issues into investment analysis and decision-making processes;
> 2. We will be active owners and incorporate ESG issues into our ownership policies and practices;
> 3. We will seek appropriate disclosure on ESG issues by the entities in which we invest;
> 4. We will promote acceptance and implementation of the Principles within the investment industry;
> 5. We will work together to enhance our effectiveness in implementing the Principles; and
> 6. We will each report on our activities and progress towards implementing the Principles.'

As at November 2014, the PRI had 1,310 signatories, including 185 UK signatories. The UK signatories included 39 asset owners (including 22 UK pension funds),[7] 116 investment managers and 30 professional services firms (including investment advisers).

Signatories commit to apply the principles 'where consistent with fiduciary responsibilities'. So a signatory is not committing to the principles beyond what fiduciary duties might require. Although social concerns feature within these beliefs, the primary belief and motivation of 'responsible investment' is the direct *value* link between ESG factors and long-term investment performance.

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7 Pension scheme signatories listed on the UN RPI website as at November 2014 include Aviva, BBC, BP, BT, Church of England, Environment Agency, M&S, NEST, Railways Pension Scheme, Royal Mail, Shell, SAUL, Pensions Trust, Unison, USS and various local authority funds.

Ethical investment, on the other hand, is the term more often used to describe investment choices and decisions which are primarily motivated by the *values* of an investor, such as his or her ethical, religious, moral or political beliefs. An example of ethical investment therefore would be the exclusion of investments connected with tobacco, alcohol, warfare or gambling industries (so called 'sin stocks') because of the moral, religious or political views of the investor.

This is not to say that values never play a part in an investor's decision to take an ESG or responsible investment approach nor that ethical investment decisions are made without any regard to value. However it is the distinction between value and values as the primary motivation of the investor that is increasingly being used to distinguish the two styles of investment. Is this value or values?

Trigger for the Law Commission review?

The trigger for the Law Commission review was an earlier review carried out by Professor Kay of the effectiveness of UK equity markets.[8]

Professor Kay identified various problems with the functioning of UK equity markets, one of which was the increasingly short term ('myopic') perspective of market participants who were effectively 'trading' in equities based on short-term movements in share prices rather than 'investing' in companies because of performance over the longer term. This had various negative effects, including companies prioritising short-term profits to the detriment of longer-term success and sustainability. This was ultimately bad for companies and investors alike.

Part of this problem, in Kay's view, was the overly conservative view taken by some pension scheme investors of what fiduciary duties required them to take into account when investing. In particular, Kay noted that some trustees believed that fiduciary duty required prioritisation of short term financial profit and did not allow trustees to take into account longer term sustainability concerns such as ESG factors when investing.

Kay therefore suggested that the Law Commission review the fiduciary duties of financial intermediaries, in particular pension scheme trustees, to clarify 'how far those who invest on behalf of others may take account of factors such as social and environmental impact and ethical standards'.

The legal framework – the three sources of obligation

The Law Commission's report contains a useful overview of the relevant legal framework applicable to investment of pension scheme assets by trustees. As noted by the Law Commission, the relevant obligations, restrictions and duties derive from three sources:

(1) the trust deed;
(2) legislation; and
(3) trust law duties – as developed over time by the courts.

The trust deed

The investment power in the trust deed is the starting point for any consideration of what a

8 The Kay Review of UK Equity Markets and long-term decision making, July 2012.

trustee can or cannot do when investing the assets of the trust. Section 34 of the Pensions Act 1995 gives pension scheme trustees a statutory power to make 'an investment of any kind as if they were absolutely entitled to the assets of the scheme'; however this statutory power is subject to any restrictions imposed by the trust. If a trust deed requires trustees to avoid investment in certain types of asset or sectors, then trustees can (and must) adhere to such restrictions when investing.

A typical pension scheme investment power will normally be very wide (and deliberately so), allowing trustees to invest scheme assets in any way they see fit and as if they were beneficially entitled to those assets. The trust will normally provide express powers to carry out ancillary activities in connection with investment that may not be covered by s 34.[9] However it is unusual, save for provisions in relation to employer-related investments, to find any substantive restrictions within the trust deed on the investments that trustees can make.

Legislation

Trustees must exercise their power of investment in accordance with statutory provisions. The key relevant provisions for these purposes are found in the Pensions Act 1995 and the Occupational Pension Schemes (Investment) Regulations 2005[10] (the 'Investment Regulations').

Section 36 of the Pensions Act 1995 imposes a statutory obligation on trustees and their fund managers to invest pension scheme assets in accordance with prescribed requirements and in line with the Statement of Investment Principles.

Regulation 4 of the Investment Regulations sets out these prescribed requirements.[11] Those of most relevance to the question under consideration are as follows:

- Investment powers must be exercised in the 'best interests of members and beneficiaries' and, in the case of a potential conflict of interest, 'in the sole interest of members and beneficiaries' (reg 4(2)). The sponsoring employer is not a beneficiary for this purpose.
- Assets should be invested in a manner calculated to ensure the 'security, quality, liquidity and profitability of the portfolio as a whole' (reg 4(3)).
- Assets held to cover a scheme's technical provisions must be invested in a manner appropriate to the nature and duration of the expected future retirement benefits payable under the scheme (reg 4(4)).
- Assets must consist predominantly of investments admitted to trading on regulated markets and investment in assets that are not admitted to trading on such markets must be kept to a prudent level (reg 4(5) and (6)).
- Assets must be 'properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings and so as to avoid accumulations of risk in the portfolio as a whole' (reg 4(7)).

9 The statutory power will not cover any activities which are not themselves 'investments' nor will it cover ancillary activities such as taking out insurance for assets where relevant. The statutory power in s 34 may not, therefore, be wide enough to cover every application of pension scheme assets by trustees.

10 Note that the Trustee Act 2000 also contains overriding duties applicable to investment by trustees, which impose duties similar to some of the requirements the Investment Regulations (for example, a statutory requirement to diversify). These provisions do not apply to occupational pension schemes by virtue of s 36 of the Trustee Act 2000.

11 Section 40 also imposes prohibitions and limitations on employer-related loans and employer-related investments.

In addition, reg 2 of the Investment Regulations requires trustees to confirm certain matters relating to their investment policy in their Statement of Investment Principles. In particular, reg 2 requires Trustees to set out the extent (if at all) to which 'social, environmental or ethical[12] considerations' are taken into account in the 'selection, retention and realisation of investments'.

Section 34 of the Pensions Act 1995 gives trustees a power to delegate the exercise of their investment functions to a fund manager.[13] If decisions in relation to the investments in question would constitute a regulated activity requiring authorisation under the Financial Services and Markets Act 2000, then delegation must be to an authorised or exempt person.

The activity of managing the investments[14] of an occupational pension scheme is deemed to be an activity carried out 'by way of business',[15] which can only be carried out by authorised or exempt persons. However, pension scheme trustees are exempt from authorisation if they are not making any 'day-to-day' decisions in relation to those investments (eg because all day-to-day decisions are delegated to an authorised manager, with trustees only taking 'strategic' investment decisions). Most pension scheme trustees are not authorised and therefore will (and must) delegate all day-to-day investment decisions to authorised fund managers.

Before making any investment decisions, pension scheme trustees are required to obtain 'proper advice' (s 36 of the Pensions Act 1995).

Trust law duties

Finally, trustees must comply with duties imposed by trust law – the principles of which have been established and developed over time by decisions of the courts. These familiar principles apply to the exercise of any discretionary power. These, for example, require trustees to:

- act within the scope of their powers;
- exercise powers for their proper purposes, taking into account all relevant factors and ignoring any irrelevant factors; and
- not fetter their discretions.

The way in which these duties apply to trustees when investing trust assets has been considered by the courts in a number of cases. Two of the key cases are *Cowan v Scargill*[16] and *Harries v The Church Commissioners*,[17] discussed below.

12 Note the reference to 'ethical' not 'governance'. This requirement dates back to 2000.

13 Under PA 1995, s 34(4), trustees will not be liable for the acts and omissions of a fund manager to whom discretions have been appropriately delegated (specifically if the trustees have taken all reasonable steps to satisfy themselves that the manager has the appropriate knowledge and experience for managing the investments of the scheme and is carrying out his work competently and in compliance with the requirements of PA 1995, s 36). Liability for breach of investment duty cannot, by virtue of PA1995, s 33, otherwise be excluded by trustees or made subject to restrictions.

14 Note that not all investments meet the FSA definition of 'investments' for these purposes. For example, real property is not an 'investment' for these purposes and so trustees *can* make the day-to-day decision to invest in property without the need for authorisation.

15 See the Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order 2001 (SI 2001/1177).

16 [1985] Ch 270.

17 [1992] 1 WLR 1241.

Case law

Cowan v Scargill

This case involved the Mineworkers Pension Scheme and arose from a disagreement between the five trustees appointed by the National Union of Mineworkers, led by Arthur Scargill, and the five trustees appointed by the Coal Board.

The disagreement related to the scheme's investment strategy. Shortly after Mr Scargill's appointment, a revised investment policy was proposed to the trustees. Mr Scargill and his fellow Union trustees refused to agree to this (or any investment strategy) unless, in line with Union policy, it excluded all overseas investments and investments in energies which competed with coal. The Board-appointed trustees considered that a decision to restrict investment in this way, taken on principle, and without any regard to financial considerations, would be a breach of the trustees' duties. The resulting deadlock finally resulted in an application to court to resolve the issue.

Mr Scargill disposed of the services of his counsel team the day before the hearing and argued the case himself. His position was that it was lawful for the union trustees to object to investment overseas and in competing industries to coal. In Mr Scargill's view, such investment 'would be to the detriment of coal and would be against the interests of Scheme beneficiaries'.

Sir Robert Megarry's judgment confirmed in no uncertain terms that the position taken by Mr Scargill and his fellow Union trustees was not consistent with the duties of a trustee when investing pension scheme assets. In his judgment he confirmed that:

- trustees should exercise their powers in the best interests of the present and future beneficiaries of the trust;
- if the purpose of the trust is to provide financial benefits for beneficiaries, the best interests of the beneficiaries are normally their best financial interests;
- the investment power must be exercised 'so as to yield the best return . . . judged in relation to the risks'. It was therefore the duty of trustees, in the interests of their beneficiaries, to take advantage of the full range of investments authorised by the terms of the trust, instead of resolving to narrow that range.

The judge did not agree that Union policy, or the promotion of the coal industry, were relevant interests for the trustees to take into account when taking investment decisions.

> 'I cannot regard any policy design to ensure the general prosperity of coal mining as being a policy which is directed to obtaining the best possible results for the beneficiaries, most of whom are no longer engaged in the industry, and some of whom never were.'

He also considered, but rejected, the argument that increasing the prosperity of the employer would also increase the prosperity of the scheme and therefore would be a decision benefitting the members. The US case of *Withers v Teachers Retirement System of the City of New York*[18] had been cited in support of this proposition. In this case four pension funds had agreed to purchase a significant amount of 'unmarketable and highly speculative' bonds

18 447 F Supp 1248.

issued by New York City. This was to try and prevent the bankruptcy of the city, which was the ultimate guarantor of the payment of the relevant pensions and it was therefore held in that case that the investment decision in question was in the best interests of the scheme members. The judge did not accept that similar arguments could apply in *Cowan*, noting that the scheme was fully funded and that no evidence had been put forward to suggest any risk of the insolvency of the Coal Board if the restrictions were not adopted.

The judge also dismissed arguments put forward in the evidence that the proposed investment restrictions would benefit the UK economy, which in turn would be for the benefit of scheme members. He considered the possible benefits for scheme members deriving from a benefit to the UK economy (as opposed to the public at large) to be:

> '... far too speculative and remote. Large though the fund is, I cannot see how the adoption of the restrictions can make any material impact on the national economy.'

The decision contemplates one exception to the general rule that the only relevant interests for trustees to consider are members' financial interests:

> 'If the only actual or potential beneficiaries of a trust are all adults with very strict views on moral and social matters ... the beneficiaries might well consider that it was better to receive less than to receive more money from what they consider to be evil and tainted sources. ... There are circumstances in which arrangements which work to the disadvantage of a beneficiary may yet be for his benefit'.

However, the judge considered that the current case was 'plainly' not within this 'rare exception'.

There has been some debate between practitioners about whether *Cowan* is a reliable authority for how trustees should exercise investment powers. Did Mr Scargill's decision to represent himself allow for proper debate and argument of the relevant legal issues? Did the extreme facts and viewpoints involved in this case provoke a dogmatic judgment, requiring no subtlety or nuance, so that caution is required before extracting general principles for wider application?

Perhaps to some extent. The reference to acting in a member's 'best interests', although now enshrined within the Investment Regulations for investment purposes, is not considered to be a particularly helpful or appropriate way of generally describing the fiduciary duties of a trustee.[19] This view seems to be shared by the Law Commission, which concludes that this 'is better thought of as a combination of existing duties rather than as a duty in its own right' and should be considered a 'shorthand' for all the other duties that apply to trustees.

Whatever view one takes of the decision, it does contain very clear statements about the purpose for which an investment power within a pension scheme should be exercised, and that when exercising that power the primary concern of trustees should normally be members' financial interests.

The more interesting and nuanced questions on whether relevant factors could include broader financial concerns, such as benefits for the economy or a benefit for the employer, were not considered at any length in the judgment and were dismissed on the facts. This is a

19 Including by Lord Nicholls, who has suggested extra judicially that this does no more than describe the requirement for a trustee to promote the trust for the purpose for which it was created. As referenced at para 3.43 of Law Commission Report No. 350.

shame for the question in hand. However, it is perhaps understandable in view of the factual background, which suggested that legal nuance might be best avoided.[20]

Bishop of Oxford (Harries) v Church Commissioners

This case concerned the investment policy of the Church Commissioners. The Commissioners managed trust assets as charity trustees in order to make financial provision for Church of England clergy.

The Commissioners applied an ethical investment policy, which excluded investment in armaments, gambling, alcohol, tobacco, on the basis that large bodies of the Church of England were opposed to these industries. The investment policy also imposed certain restrictions on investments in companies with South African connections because of apartheid.

The Bishop of Oxford asked the Commissioners to adopt more stringent restrictions in relation to South African investment. The ethical policy operated by the Commissioners excluded approximately 13 per cent of UK listed stocks. The additional measures proposed by the Bishop of Oxford would have increased this excluded percentage to 37 per cent, including 65 per cent of the oil sector and 62 per cent of the chemical sector. The Commissioners declined to adopt the additional restrictions as they felt that the resulting lack of diversification would be imprudent and against beneficiary interests.

The Court was asked to consider whether the Commissioners were placing undue importance on financial considerations when investing and whether they should be obliged (or permitted) to have regard to considerations of Christian purpose and ethics when investing, even if this would or might be financially detrimental for the trust.

Sir Donald Nicholls V-C heard the case. He confirmed that the investment power should be exercised to further the purpose of the trust, which in most cases would be to generate money for the charity. 'Most charities need money; and the more of it there is available, the more the trustees can seek to accomplish'.

He confirmed that in most cases the best interests of the charity will require trustees to select investments solely on the basis of well-established investment criteria – having due regard to such matters as the need to diversify, to balance income against capital growth and to balance risk against return. He confirmed that trustees should not 'use property held by them for investment purposes as a means of making moral statements at the expense of the charity of which they are trustees'.

However, he noted that there could be exceptions to this general principle 'in a minority of cases':

- If an investment would conflict with the objects the charity is seeking to achieve, in which case the investment should not be made – even if this results in financial detriment.
- If investing in a certain way might hamper a charity's work by alienating donors or making the recipients of the charity's aid unwilling to accept it. In such circumstances, trustees should balance the potential harm to the charity against the financial detriment

20 The judgement records that Mr Scargill had asserted in correspondence with the Board trustees on frequent occasions that previous legal advice received by the Union supported the position of the Union trustees. However he refused to share a copy of such advice until Day 4 of the hearing. At this point it transpired that Mr Scargill's assertion was based on one sentence extracted from an 18-page note of advice. According to the judge, the rest of the 18 pages of advice was otherwise 'generally in accord with' the views expressed by him in his decision.

of excluding the relevant investment. The greater the risk of financial detriment from the investment decision, the more satisfied trustees should be of the resulting detriment to the charity before they incurred that risk.

- The court also considered the position if different moral views were held by beneficiaries as to what sorts of investment would, or would not, conflict with the objects of a charity, recognising the necessary difficulty of identifying 'common' views on moral questions, where frequently 'there are no certain answers'. In this situation:
  - Trustees may accommodate the moral views of certain beneficiaries who consider that an investment would conflict with the objects of the charity, provided the trustees are satisfied that this would not involve a risk of significant financial detriment;
  - Otherwise, trustees should not prefer one moral view over another.

The court noted that the existing ethical investment policy of the Commissioners appeared to be in line with these principles. However, it was also right for the Commissioners not to adopt further restrictions in order to promote moral views that may not be held by all beneficiaries at the risk of financial detriment to the trust.

The judge believed that his views, and the exceptions contemplated, were consistent with the views expressed by Sir Robert Megarry V-C in *Cowan*, noting specifically that Sir Robert 'was considering trusts for the provision of financial benefits for individuals' whereas in this case he was 'concerned with trusts of charities, whose purposes were multifarious'.

The exceptions contemplated in this case follow, in my view, from the general principle that powers should be used for their proper purpose to promote the objects of the trust. The first exception arises where there is a conflict between two purposes of a trust, as might arise in a charitable trust. The first purpose is to promote the charity's objects and the second is to raise money in order to do so. Promoting the charity's objects can, therefore, displace the general presumption that the investment power must be exercised based on financial considerations only. Sir Donald noted that this multiplicity of purpose is not a feature shared by a pension trust, which has a single purpose of providing financial benefits for members.

The second exception (so taking account of the risk of alienation of donors and recipients) might be analysed as an extension of the same principle of promoting the trust. Alternatively, it could simply be characterised as a decision based on financial factors. An investment decision taken to avoid financial detriment for the trust (ie curtailment of donor support) is itself motivated by financial concerns – a concern about reducing the financial returns generated from donor contributions rather than investments. This alternative construction does perhaps have an analogous application to a pension scheme, to the extent that certain investment decisions might either promote, or be harmful to, the sponsoring covenant of the employer, which is important to the financial success of the scheme, an idea which is explored further below.

What can trustees take into account when investing: conclusions of Law Commission[21]

Distinction between financial and non-financial factors

The Law Commission starts with the basic trust principle that powers must be exercised for their proper purpose. In the Law Commission's view, the proper purpose of a pension scheme

21 Law Commission report 'Fiduciary duties of investment intermediaries' (June 2014).

investment power is 'to secure the best realistic return over the long term, given the need to control for risks'.

Any factor relevant to balancing investment returns against investment risks is relevant to this purpose and can be taken into account by trustees. The Law Commission distinguishes these relevant 'financial factors' from 'non-financial factors', which have much more limited application in investment decision-making.

The Law Commission considers this distinction between financial and non-financial factors to be key in determining what trustees can take into account when investing. Crucially, the Law Commission confirms that factors relating to the assessment of risks in relation to an investment over the longer term can properly be characterised as financial factors. This characterisation of a financial factor is how the Law Commission brings ESG factors within the scope of permitted investment considerations and is discussed further below.

Factors which do not relate to the assessment of investment returns or risks ('non-financial' factors) will not, generally, be relevant to achieving the purpose of the investment power within a pension scheme. This will include factors motivated by moral, social, or political concerns and so will include most (if not all) forms of ethical investment. The Law Commission confirms that trustees should *not* take such factors into account when investing, save in limited circumstances which are discussed below.

Non-financial factors and ethical investment

The Law Commission identified three exceptions to the general proposition that non-financial concerns or factors are not relevant considerations for investment decisions within a pension scheme:

- If trustees have good reason to think that members share the relevant concern *and* there is no risk of significant financial detriment by investing to reflect that concern. The two limbs of this general test, which should be considered together, are discussed in more detail below, together with the additional flexibility that the Law Commission notes might exist for 'affinity groups' when applying this test.
- If permitted by the trust deed. Investment must always be in accordance with the trust deed. Trustees must comply with any restrictions on investment to reflect non-financial concerns regardless of whether a restriction is driven by financial or non-financial motivations.
- If this is a DC investment option**.** Trustees may give members ethical investment options, or any other investment option based on non-financial factors, as part of a DC fund choice. In this case, the member is effectively consenting to the application of the non-financial factor within the investment decision and the financial consequences that flow from this.

The general test (1): trustees have good reason to think members share concern

The first part of the general test for the use of non-financial factors is that trustees must have good reason to think that scheme members share the relevant concern. This appears to reflect the possible exceptions contemplated in *Cowan* and *Harries* as to when investment decisions might properly be influenced by non-financial factors.

The Law Commission offers no definitive view as how trustees might satisfy themselves that this member viewpoint test is met in practice, saying that:

> 'we think that the courts would judge the issue in the round, focussing on whether trustees applied their minds to the right question and sought the answer in a reasonable way'.

The Law Commission suggests that a member poll could be used to determine member views, but explains that 'we do not think that there needs to 100% agreement. If the majority are opposed to an investment whilst the rest remain neutral, we think that would be enough'. The suggestion that a poll might elicit a majority view from members (in which all respondents will express the same view) suggests a more optimistic view of member engagement levels than trustees may have experienced previously.

The Law Commission suggests that in some cases trustees may be able to make assumptions about member views without carrying out surveys. The example given in the report is investment exclusions related to activities that, although legal, contravene international conventions, such as the manufacturing of cluster bombs or landmines.[22] The Commission notes that the existence of an international convention banning cluster bombs may make it reasonable for trustees to think that 'many people would consider them to be wrong'. However, more may be required before trustees can safely rely on this assumption for the scheme. The Law Commission goes on to explain: 'When coupled with letters from members agreeing, and no letters disagreeing, we think that trustees would have good reason to think that they were acting on member concerns'.

The practicalities of establishing member views by any method will present significant challenges for trustees. Is this something on which trustees will want to spend time and resources? Will any sort of poll or survey give trustees a sufficiently certain idea of the views of the majority of the scheme membership, especially if the majority of scheme members are unlikely to reply? Does the lack of any response in itself indicate something about the strength of views (or otherwise) held by the non-responders?

If this is a permissive *exception* to the general rule, rather than part of the rule itself (so assuming that there is no *positive* prohibition on trustees investing in a way which is against member views)[23] then how much effort (and money) is it appropriate for trustees to expend in establishing whether such an exception exists? Establishing member views to the level required to justify the use of non-financial factors may not, therefore, be a road that many trustees will have the appetite to travel (especially if the chances of arriving at any recognisable destination at the end of it are uncertain).

The general test (2): no risk of significant financial detriment

This second limb of the test must be assessed at the time the decision is made (without applying the benefit of hindsight) and the courts will allow trustees discretion on how this is assessed. The requirement is not that all risk of theoretical detriment should be avoided, but merely that trustees should not incur the risk of significant detriment.

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22 This example is a common investment exclusion for institutional investors, particularly in Europe. According to the Eurosif 2014 European SRI survey, the most common investment exclusion applied by survey respondents (for those who applied exclusions as part of an investment policy) is to reflect the international conventions on Cluster Munitions and Anti-Personnel Landmines. In Belgium, France and the Netherlands, legislation prohibits investors from investing in these activities.

23 The question of whether non-financial factors *must* be considered where the relevant tests are met is not directly considered by the Law Commission. The closest authority is *Harries,* which supports the proposition that ethical factors must be considered in investment where to do otherwise would result in an investment which conflicted with the object of the purpose of the trust – but this does not really translate to a pension trust which itself is unlikely to have any conflicting object.

In particular, the Law Commission recognises that decisions that reduce diversification will not necessarily carry a risk of significant financial detriment. The extent to which a limitation imposed on investment options carries a risk of detriment because of diversification concerns is a matter of degree and one for the trustees to determine. In *Harries*, therefore, the court did not interfere with the Commissioners' views that adopting investment restrictions excluding 13 per cent of the UK market was not detrimental but that increasing the restriction to 37 per cent would be.

Balancing the tests

The Law Commission's view is that the two limbs of the test would be considered together by a court in the round. If there is a very strong 'member view', then it may be acceptable for trustees to accept a greater degree risk of financial risk. Conversely, the less risk there is of financial detriment, then there may be greater flexibility in the strength and extent of member views that must be established.

Affinity groups

These are schemes set up by and for groups, the members of which are likely to share particular common moral or political viewpoints – such as schemes attaching to charities or religious or political organisations.

For such schemes, the Law Commission considers that greater flexibility may exist in relation to ethical investment. For example:

- it may be easier to infer a common member view on certain moral, political or ethical issues relevant to an investment decision;
- compelling evidence of very strong views may justify a greater risk of financial detriment. This appears to be part of the Law Commission's general conclusions. However it may be that the Law Commission considers that affinity group schemes will be the ones where very strong member views are most likely; and
- for DB schemes, the Law Commission notes that the impact of investment decisions on the employer's business can also be taken into account by trustees 'with a view to safeguarding the employer's funding covenant'. If the employer is a charity, the Law Commission confirms that it may be appropriate for the trustees to avoid investing 'in a way that would reduce support for the charity by taking decisions which would reduce support for the charity by alienating donors or recipients'.[24] This would need to be 'weighed against the strength of the employer covenant and the risk of a call on the PPF'.[25] This example appears to be lifted directly from the exceptions described in the *Harries* judgment.

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24 There are well-publicised examples of where investment decisions have caused such problems for charitable trusts. Consider for example the pressure put on the Church Commissioners to disinvest from Wonga and the major review of investment strategy forced on the Comic Relief trustees further to the BBC *Panorama* documentary which highlighted the investments held by this charity in industries which conflicted with the causes supported by Comic Relief (in particular investments in arms, alcohol and tobacco industries).

25 This reference to the PPF is odd. Trustees will, of course, want to avoid acting in a way that leads to the insolvency of their employer (an event which could trigger PPF entry). Trustees are not otherwise concerned with reducing calls on the PPF.

Ideally, however, the Law Commission thinks that if specific investment restrictions are to apply to investment by affinity group pension schemes, 'these should be written into the scheme rules'.

This is an uncontroversial statement for schemes that have such restrictions incorporated into the trust provisions from the point of establishment. Incorporating new restrictions into scheme rules by subsequent amendment does not, however, necessarily give trustees an easy way of side stepping the legal tests as to when ethical investment is appropriate. Trustees wanting to make such an amendment would need to be satisfied that it was appropriate to do so. If trustees concluded that restricting investment in the manner proposed (under the current investment power) could *not* be justified because of the risk of financial detriment to beneficiaries, then could they conclude it was appropriate to amend the rules to incorporate such a restriction? Conversely, if they believed that it *was* appropriate to make an amendment to limit investment in this way, then could they not apply the investment restriction under the current investment power? Amendments which widen powers might be necessary to enable trustees to do something that could not otherwise be done. Whether amendments should be made, or are necessary, to restrict the scope of a power raise more interesting questions.[26]

Does the case law support the test as set out by the Law Commission?

Aside from practicalities, it is submitted that a more fundamental concern with the conclusion that member views can justify the use of non-financial factors when making investment decisions. Does the case law support the basis for such an exception in the context of a pension scheme?

This exception appears to be based on statements in *Harries* and *Cowan* as to when an investment power under a trust can be exercised for non-financial considerations. Do these exceptions translate to pension schemes?

The *Cowan* exception is referred to by the judge in the context of some general observations on trust law – and not in the specific context of a pension scheme. He describes the exception in the following terms:

> '. . . if the *only* actual *or potential* beneficiaries of a trust are *all adults* with *very strict views* on moral and social matters'.

The judge takes great care with his definition of the class of members who must hold the relevant views in order for this exception to be in play. For these purposes, the relevant views must be shared not just by the majority of the current class of beneficiaries, but by *every* current and *potential* beneficiary. Further, all such beneficiaries must be adults. This exception is defined in terms similar to, and perhaps in the judge's mind was based on, the principle established in *Saunders v Vautier*,[27] which is that all beneficiaries of a fixed trust acting collectively and with legal capacity can wind up or amend the trust or excuse trustees from breach of trust.

In addition, the exception as contemplated in *Cowan* is not invoked where members have common views – but where the members have '*very strict views*'. Does this import

26 See David Pollard's article 'Fettering discretions – no longer a good excuse' (2014) 28 TLI 105 and 191 (from the same APL conference) for further discussion of this issue.

27 *Saunders v Vautier* (1841) confirmed the principle that such beneficiaries can wind up the trust; this principle has been extended subsequently in other cases to also allow amendment of the trust provisions (see *Capral Fiduciary v Capral Aluminium NZ* (1999)).

something over and above a strongly held view? For example, does this refer to views which dictate certain standards of behaviour from those holding them, as is the case for certain religious beliefs, as opposed to just shared 'preferences'?

In any event, the class of beneficiaries of a pension trust will normally be far wider than that contemplated in the *Cowan* exception, for one or more of the following reasons:

- **Size** For extremely small schemes, trustees might be able to establish that all beneficiaries hold the same strict views. Indeed, for some small self-administered schemes, the trustees and members may be the same people. However, for most occupational pension schemes, it is unlikely that all members will hold the same views. Even within affinity group schemes, not all current active members will necessarily share the same ethical or moral beliefs as their employer. It becomes even more difficult to ascribe such views to deferred and pensioner members who are no longer working for that employer and less likely again in relation to spouses and dependants of members who could also be actual or potential beneficiaries of the trust.
- **Potential beneficiaries** Even if a scheme is closed to new entrants, a scheme that provides survivor benefits may have actual and potential beneficiaries whose identities (and therefore whose views) cannot be known. This would include individuals who could later become spouses and partners of members and unborn children.
- **All beneficiaries are adults** Where survivor benefits are payable, a scheme's actual and potential beneficiaries could include children. The *Cowan* exception as contemplated requires all actual or potential beneficiaries to be adults.

The exceptions contemplated in *Harries* also have to be treated with caution as these relate to a charitable trust, the powers under which must be exercised consistently with the objects of that trust (ie the charity). This is not a feature shared by a pension scheme trust, which has a single object of providing the scheme's benefits. The exceptions deriving from the multi-object aspect of a charitable trust do not translate in the same way to a pension scheme[28] (although see below for discussion of an analogous argument that might apply instead).

Whatever uncertainties exist over this part of test, the financial detriment limb of the test may be more significant in practice. In *Cowan*, the judge considered whether trustees might properly take account of social or political factors where this resulted in no financial detriment for the trust. Whilst not accepting the proposition 'in its full width' the judge accepted that 'if the investment in fact made is equally beneficial to the beneficiaries, then criticism would be difficult to sustain in practice, whatever the position in theory'.

Even if it is difficult to find a valid basis in law which justifies the use of non-financial factors in a pension scheme where this reflects member views, if trustees are satisfied that such an investment choice brings with it no risk of financial detriment, then it is difficult to foresee challenge to such a decision. Provided trustees consider that they can appropriately diversify their investments after applying an ethically based exclusion, then financial detriment may be hard to establish and legal challenge unlikely.[29]

28 And the judge in *Harries* expressly noted this difference when commenting on whether his decision was consistent with that given in *Cowan*.

29 Indeed, trustees might be more likely to be challenged for *not* applying an ethical investment policy, which was the case in *Harries*. See also for example the recent campaign launched by members of the Universities Superannuation Scheme (October 2014) who want the USS trustee to take a more ethical approach to investment, although it is unclear from some press reports whether members are campaigning for more ethical investment or more ESG investment or both.

Relevance of employer views in a DB scheme?

In a DB pension scheme it is the employer, not the members, that bears the primary risk of investment performance. Members only share in that risk in an indirect way, in that investment performance and volatility could affect the benefits the scheme could ultimately provide in the event of an employer failure.

A DB scheme is not, therefore, an example of a situation where members 'might prefer' to receive a smaller benefit knowing that it derives from what they perceive to be 'purer' sources (as per the exception contemplated in *Cowan*). Instead it is the employer that must meet any downside cost of pursuing a particular investment strategy. Why should the employer have to take any financial risk, significant or otherwise, to indulge the moral views of its beneficiaries?

The principle behind the *Cowan* exception is that a person might prefer trust powers to be exercised to his or her financial disadvantage if that exercise reflects his or her moral views. It is arguable that it is the views of those who will in fact incur the financial disadvantage (or take the risk of this) that are most relevant here. In a DB scheme, this would include the employer sponsor as well as the beneficiaries.[30] If the members of a pension scheme hold strong common views, then this may be because the scheme is attached to an employer organisation that also holds the same views. In this case employer and member interests might be aligned in any event. However, this does not necessarily mean that the employer will always share those views sufficiently to underwrite any investment underperformance that might result from reflecting such views in the investment strategy of the scheme.

Relevance of employer covenant in a DB scheme?

Regardless of what views are held by members and employers, should trustees of a defined benefit scheme also consider the employer covenant as part of any decision to adopt non-financial factors when investing? The 'integrated approach' to funding promoted by the Pensions Regulator requires trustees to consider whether the employer covenant can properly support the scheme's investment strategy. This would seem especially important for decisions about ethical investment approaches, which may come with an associated financial cost.

Conversely, if the employer covenant *is* sufficiently strong, can trustees take this into account when deciding if there is a risk of financial detriment from investment decisions based on non-financial factors? If the covenant can support a lower investment performance (and the employer supports the relevant investment approach) can trustees conclude that there is no risk of financial detriment for members, even if the investment approach itself risks delivering lower returns?[31] This link to employer covenant is not discussed in the Law Commission report.

A point given only limited consideration by the Law Commission is the reverse question; the extent to which the effect of an investment decision *on* the employer's covenant can be a relevant factor that trustees can take into account when investing.

30 Some might argue that the employer falls within the definition of beneficiary in any event, but the Law Commission was not persuaded by this. The employer is not included as a beneficiary within the Investment Regulations either.

31 By way of extreme example, if an employer was prepared to expressly underwrite the adoption of a particular investment strategy by committing to pay additional contributions if the strategy performed below a selected benchmark, then surely this would eliminate any risk of financial detriment (if the trustees were satisfied the employer could pay those contributions)?

The Law Commission recognises the relevance of this for affinity group schemes. It notes that a pension scheme attached to a charity need not invest in a manner that may be detrimental to the employer covenant by alienating donors or recipients. This is directly lifted from the exception discussed in *Harries* in relation to investments held by the charity itself. This factor does not, however, relate to the performance of the investment itself. It is unclear therefore whether the Law Commission thinks that the impact on the employer covenant is relevant only as part of trustees' consideration of the 'financial detriment' part of its general test for applying non-financial factors, or whether the Law Commission considers that the impact *on* the employer can be a free standing relevant factor that trustees of affinity group schemes can take into account when investing (and regardless of member views).

As discussed above, the basis[32] for the *Harries* exception for a charitable trust may not directly translate to pension schemes. However, whilst a pension trust may not have the same objects as its employer built into the trust itself, the financial success of the employer is clearly relevant to the pension scheme achieving *its* object of providing pensions to members.

In my view, the impact on the employer covenant is normally a relevant factor that the trustees of a defined benefit pension scheme can take into account when exercising any power, including investment powers.[33] This should not be a concept restricted to affinity group schemes, or be limited to part of the 'general test' for the use of non-financial factors (and so only relevant if trustees have first established common member views).

Of course the circumstances in which this factor is relevant, the weight that trustees might give to it and how it should be balanced against other relevant factors when investing raise more difficult questions. In *Cowan,* the argument that the proposed investment restrictions would be beneficial for the employer, and therefore beneficial for scheme members, was dismissed on the facts. But this was in the context of a fully funded scheme and not a situation where the judge considered that the employer's business would be materially adversely affected if the restrictions were not adopted. However, there could well be circumstances in which the interests of the sponsoring employer could be a relevant factor for the trustees to take into account when exercising investment powers, because of a positive or negative impact on covenant.

Financial factors and ESG investment

As discussed above, the Law Commission's category of financial factors includes any factor relevant to the assessment of investment risks and returns, including long-term risks and long-term returns. If trustees consider ESG factors to be financially material to investment performance, including risks to performance, the Law Commission considers the factors to be financially relevant and ones that can be taken into account. Indeed, if trustees consider such factors to be financially material, then the Law Commission suggests that trustees *must* take these into account.

Financial factors may, therefore, include ESG factors. However this does not mean that all ESG factors will be financial factors, nor that an 'ESG' factor will be relevant just because it is labelled as such. The Law Commission explains in its report:

32 That is, the exercise of trust powers to promote the trust must not conflict with the objects of the charitable trust.
33 There can, of course, be circumstances where the investing to support the employer also carries risks as well as benefits for the scheme, for example, investing in the employer itself. Most of the tension that can arise here has been removed by the statutory restrictions on employer-related investment (see s 40 of the Pensions Act 1995).

> 'The ESG label is ill-defined; it covers a wide variety of risks, and many different approaches. The fact that a particular factor is conventionally classified as an ESG factor will not be conclusive as to whether it is financially material to a particular investment'.

Equally, the Law Commission is not saying that all trustees must be adopting an ESG approach just because some ESG factors can be categorised as financial factors:

> 'It is not necessarily helpful to say that Trustees "must" take an ESG approach . . . the duty may be put in the following terms. When investing in equities over the long-term, trustees should consider, in discussion with their advisers and investment managers, how to assess risks. These include risks to a company's long-term sustainability'.

Although the Law Commission is not suggesting that trustees *must* consider financially material ESG factors, the reference to considering long-term sustainability risks might be viewed by some as a nudge in that direction. However, taking account of ESG considerations is not the only way for trustees to assess long-term risks when taking investment decisions. Trustees might assess sustainability risks using other factors or, having considered risks to long-term sustainability, might decide that there are other, more important, investment risks that should be given priority. Taking account of a relevant factor means it is considered together with other relevant factors; it does not necessarily mean it will take priority over other relevant factors, which factors might include any additional cost involved in adopting a particular of investment approach.

The Law Commission's conclusions do, however, provide a neat and logical analysis for how ESG factors can be taken into account by those trustees who want to use them. Has this met the Law Commission's aim of enabling ESG factors to be categorised as financially relevant for those trustees who want to use them, and finally put to bed the debate about whether ESG factors are relevant? I think the answer to this is yes, to some extent. However there are some limitations and questions that remain and the theory might not always be capable of such neat application in practice. Some challenges and issues are discussed below.

Issue 1: ESG motivations

Value or values?

An investor's motivation is key to the Law Commission's characterisation of an investment decision and in particular whether it is driven by financially relevant 'value' considerations or non-financial 'values' which must meet the stricter tests discussed below.

An example given by the Law Commission is a decision to avoid investment in tobacco industries and products. This would be based on financial factors if the exclusion is due to concerns about future litigation risks or increased regulation having an adverse effect on the long-term performance of tobacco stocks. But it would be driven by non-financial factors if the decision was motivated by a moral or ethical view about smoking or the desire to achieve a cleaner environment.

This sort of clean distinction may not be so easy to identify when examining the ESG investment motivations of trustees, which in practice are often influenced by both 'value' and 'values'.

For example, a company's use of child labour (including in its supply chain) is a social

factor that might be considered as part of an ESG approach, with investment in companies that use significant child labour restricted or avoided. What are the motivations for this? Is it that:

- the significant use of child labour indicates higher risks to company reputation and brand and customer loyalty, which are important for on-going investment performance?
- the use of child labour is not a social structure which is conducive to the generation of long term investment performance within a progressive society?
- exploitation of child labour is against the investor's social values?

Another example might relate to environmental factors and a company's energy use. An investor's motivations for investing in companies that are efficient in their use of energy might be:

- the operational efficiency of companies which have low rates of energy consumption;
- that resource management and conservation is important for the long-term sustainability of all businesses which depend on these resources; or
- a desire to live in a cleaner environment.

If only 'value' motivations are relevant to a trustee's investment decision making, then the last reason set out in the above examples would not be relevant to the decision.

Directly or indirectly relevant to investment performance?

If ESG factors are taken into account because of their positive impact on long-term sustainable investment performance generally, rather than their direct relevance to the performance of the specific investments held by the scheme, are such factors still 'financial factors'? The Law Commission approach suggests that an ESG factor is only relevant if there is a direct correlation between the factor and the risk to or return from the investment under consideration:

> 'in every case, the test must be, what are the associated risks with *this* investment'.[34]

In Cowan, the arguments that the investment restrictions could be supported because of wider benefits to the UK economy were dismissed as 'far too speculative and remote'.

Any motivations which are driven by more holistic views of the investor, such as a desire to promote principles of sustainable investment more generally because of the wider benefits this brings to society or the environment, may fall outside of the financially relevant categorisation. This would reduce the list of permissible factors even further. Only the first of the three reasons in the examples set out above would clearly count as a permissible motivation. If trustees' motivations fall into the second two categories (and the first reason on its own is not a sufficient reason for use of the factor), then the more restrictive tests discussed above for the use of non-financial factors might be in play.

34 The Law Commission acknowledge that trustees can take into account the impact on the portfolio as a whole when making an investment decision, in its discussion of whether a positive impact on the UK economy is a relevant concern for trustees to take into account.

The issue is even starker where there may not be any direct benefit/risk or relation between a particular factor and the investment. For example, an investor might avoid investment in a particular company because of its approach to tax (such as the approaches of companies like Google, Apple and Starbucks which have attracted regulatory and public scrutiny of their tax affairs), on the basis that the tax strategies adopted are bad for the general economies and social structures of the countries in which those entities operate. However, if the tax approach has in fact benefitted (significantly) the company in question and in a manner that outweighs any adverse reputational consequences for the company, then the motivations for applying this tax factor would seem to be 'non-financial' under the Law Commission analysis. In which case the more onerous tests discussed above would apply.

Issue 2: Day to day or strategic decisions?

'Managing investments' is a regulated activity for pension scheme trustees. Unless pension scheme trustees have FCA authorisation, it is an offence for them to make day-to-day investment decisions, which must be delegated to properly authorised managers or exempt persons. Trustees may only take strategic decisions in relation to these investments, such as determining asset allocation, benchmarks and hiring and firing investment managers.

There would appear to be a certain tension between the Law Commission's guidance to trustees on how ESG factors should be taken into account by trustees and the regulatory framework described above. The guidance makes clear that trustees cannot adopt a 'general' ESG approach because not all ESG factors are relevant to all investments and that trustees must consider whether any specific ESG factor is or is not relevant in relation to the risks of each particular investment.

> 'The fact that a particular factor is conventionally classed as an "ESG" or 'ethical" factor will not be conclusive as to whether it is financially material. Nor will a factor that is financially material in respect of one investment always be financially material in respect of others. In every case, the test must be: what are the risks associated with *this investment*.'[35]

Trustees will not normally be involved in the selection of individual stocks within a portfolio, as this is a day-to-day decision that is not within the remit of trustees. Yet the Law Commission's guidance seems to suggest that the application of ESG factors must be considered for each individual specific investment, which would suggest it forms part of the stock selection decision. Leaving aside the practicalities of whether trustees have the time and resources to be carrying out this 'investment by investment' risk analysis, it is difficult to see how trustees can safely get involved in such decisions from a regulatory perspective, as opposed to leaving these decisions to authorised investment managers.

If the use of ESG factors is limited to a value-based assessment as to what and how specific factors might be relevant to the risks or performance of individual investments, then is ESG application, in fact, simply a question of how an investment manager applies his or her investment judgement and skills in managing a portfolio? Can trustees properly give any strategic direction here, especially if the risks vary from one investment to another? Do they have the relevant knowledge and skills to do so? We would not expect trustees to start giving strategic direction in relation to other aspects of how an investment manager takes decisions

35 Paragraph 6.31 of the Law Commission Report.

in relation to portfolio management; why should this be different for ESG factors? Is the extent and way in which investment managers take account of ESG factors simply part of the investment style of a manager?

In my view it is certainly questionable (at best) whether trustees can or should be carrying out the sort of exercise contemplated by the Law Commission in relation to the application of ESG factors. This is for reasons of practicality and because of the risk that trustees find themselves making day-to-day investment decisions in doing so.

However, there are other strategic investment decisions that trustees can take in relation to the use of ESG factors. Trustees can make decisions about their general investment beliefs, in particular their investment time horizon, their views on risk and return and whether risk factors should be considered by reference to a broader range of factors (such as those falling under the ESG umbrella where relevant) or in another way. Manager selection is also a strategic trustee decision and trustees can therefore select investment managers to reflect their investment beliefs. A trustee can consider a manager's approach and philosophy in relation to ESG factors and select those managers whose philosophy best fits with the trustee's views on the use of ESG factors in the investment of scheme assets. As well as specialist ESG focussed managers, some 'conventional' investment managers now incorporate ESG integration within their general investment management approach.

Other strategic ESG decisions that could be taken include 'thematic ESG' investment decisions, to the extent that this involves the selection of particular asset sectors – provided of course this is based on financial considerations. Also, trustees can certainly apply ESG factors in their approach to stewardship activities and the approach they and/or their mangers take to engagement and voting.

Trustees who incorporate ESG into investment decisions will, however, need to consider carefully their motivations for these decisions. If an ESG approach genuinely provides a better risk adjusted return, then trustees might expect their investment managers to be taking relevant ESG factors into account in any event – without this forming part of an additional strategic overlay that is directed by the trustees. The reality may be that those trustees with strong strategic ESG investment beliefs might also be more likely to be motivated in those beliefs by 'values' that go beyond the financial.

Issue 3: Evidencing ESG benefits

'However beautiful the strategy you should occasionally look at the results' – Sir Winston Churchill

The justification for using ESG is that there is a positive link between ESG factors and long-term investment performance and risks. If this is not the case, then ESG factors are no more financial in nature than moral, religious or political motivations.

There have been numerous academic studies looking at the impact of ESG factors.[36] Some of these show a positive link between ESG and investment performance; others are

36 A paper 'Sustainable Investing – Establishing Long-Term Value and Performance' by Deutsche Bank Group (Mark Fulton et al) (June 2012) analysed over 100 academic studies, 56 research papers, 2 literature reviews and 4 meta studies in this area. The paper concluded that a clear majority of academic studies showed mixed or neutral correlation between 'socially responsible investing' and investment performance – although the authors concluded that the investment approaches considered under this heading were more likely to be based on ethically driven exclusions, such as never investing in tobacco stocks. By contrast, the authors found a strong link between companies scoring highly on ESG factors and the individual performance of those companies, which suggested a positive link between investment approaches incorporating ESG integration (such as 'best in class' approaches) and investment performance.

more circumspect or point in the other direction. ESG approaches are also likely to be more expensive to deliver than conventional strategies, as they require a broader consideration of factors. Do trustees need to show demonstrable benefit (outperformance by contrast to non ESG approaches) to justify their use? Probably not. Like many economic theories, ESG is based on rational belief – not necessarily evidenced belief. Trustee decisions are not judged with hindsight, but by reference to the reasonableness of the decision based on known facts at the time the decision was made.

The fact that ESG factors are linked to *long-term* performance and risks means that objectively evidencing this is also subject to obvious constraints. If an ESG approach has not outperformed a non-ESG comparator approach over a particular reference period, then ESG supporters may argue that the reference period has not been long enough for the longer term benefits to have emerged. In addition, when it comes to using ESG factors as a means of avoiding risks (in particular lurking 'black swans') then it may be impossible to evidence whether the ESG approach has or has not achieved its objective, on the basis that the investor will not see those risks that have in fact been avoided. As Professor Kay explained:

> 'locking the door when leaving the house is a costly strategy most of the time but usually profitable in the long run (although it is rarely possible to know whether it has in fact been profitable).'

If trustees *do* genuinely believe that ESG factors are relevant to long-term financial performance, then an interesting question to ask is whether those trustees also take account of such factors when reviewing their employer covenant? The sustainability and long-term performance of the employer or employers responsible for funding the scheme will normally be of far greater significance for the trustees and members than the performance of individual investments. If trustees consider it important to integrate ESG factors within investment decision making, should they also be considering these factors when reviewing the long-term risks to, and performance of, their own employer covenant?

ESG and other asset classes

The Law Commission report and guidance focus on the relevance of ESG factors in relation to investment in UK equities. This is understandable given that the Kay Review of UK equity markets[37] provided both the context and trigger for the Law Commission's consideration of the question.

However, as Kay himself recognised, pension scheme trustees are becoming an increasingly minor player in the UK equity market. Kay reported that the combined holdings of pension funds and insurance companies amounted to only 20 per cent of the total market. Defined benefit pension schemes implementing risk reduction 'flight paths' to self-sufficiency and/or buy-out will be further reducing their exposure to equities, perhaps to nil, and moving into other asset classes. For these schemes the investment time horizon might not be 'long-term' at all. Is any of the debate on ESG factors relevant for such schemes?

ESG approaches are not confined to equity investments. ESG can form part of the investment approach in a number of other asset classes. In particular:

37 'The Kay Review of UK equity markets and long-term decision making' (2012).

- **Property** Property is an obvious asset class where ESG factors (in particular the 'E' component) can be relevant to the performance of the property as an investment.
- **Private equity** This is investment in portfolios of unlisted companies rather than listed companies. But it is still investment in companies, for which ESG factors can be relevant to current and future performance. Some private equity managers are now expressly incorporating ESG factors into their selection and management of portfolio companies (although they may be more interested in ESG issues which affect performance in the short to medium term).
- **Corporate/sovereign bonds (fixed income)** Although the return from such investments is 'fixed', that return is dependent on the continued solvency of the issuer. The value of the bond holding is therefore affected by the credit rating of the issuer. ESG factors are used by some fixed income managers to assess credit rating on the basis that consideration of the broader suite of ESG factors can play a similar role in evaluating the credit risk of the issuer as they do in evaluating the investment risk of an equity investment. In the case of sovereign bonds, ESG factors are similarly applied but by reference to systemic issues as they affect the relevant state (and the credit risk of the sovereign) as opposed to an individual corporate.

For schemes moving towards buy-out in the short to medium term, it may be harder to justify an ESG approach. Much of the value of ESG factors relates to the assessment of *long-term* performance and risks, which may not be relevant to such schemes. ESG approaches might be considered to reduce investment volatility, a particularly important consideration for schemes moving to buy-out. However, the decisions made by trustees on asset allocation, with the aim of holding assets that move in line with insurance company pricing, will be far more important in managing these risks than the investment styles used within the chosen asset classes.

Conclusions on ethical and ESG investment

In its consultation paper, the Law Commission said that it hoped to 'remove finally the misconception that trustees cannot take into account ESG factors'. In its final report, the Law Commission noted its hope 'that this report and our conclusions will assist in dispelling the uncertainty' as to what the current legislation permits trustees to take into account. Has the Law Commission achieved its aims?

Crucially, the Law Commission does not try and dislodge the general proposition that financial considerations remain the primary concern for trustees when investing. Whilst other factors may be brought into the equation, these factors are subordinated to financial objectives and are subject to tests the application of which could be problematic both in theory and practice. It would seem difficult therefore to find a place for ethical investment within a pension scheme, unless the investment is authorised by the trust deed or forms part of a DC fund choice.

It is a shame that the Law Commission does not explore in any depth the relevance of the employer covenant in justifying investment decisions based on non-financial factors and how this fits into the tests identified. Covenant may be relevant because of the impact of investment decisions *on* the covenant (which I would argue can be treated by trustees as a relevant 'financial factor' in appropriate cases). Or it could be relevant because a sufficiently strong employer covenant might enable trustees to conclude that there is no risk of significant financial detriment arising from investment decisions based on non-financial factors.

The Law Commission's definition of the purpose of an investment power, and the wide definition it gives to 'financial factors' (in particular to include longer-term risk considerations) certainly give scope, and perhaps a fairly broad one, for ESG factors to form part of the investment approach taken by pension scheme trustees. However, limitations remain. ESG investment based on 'values' or more holistic sustainability aims may fall the wrong side of the key financial/non-financial divide. Trustees who want to take an ESG approach will have to be vigilant about their motivations for doing so or be confident that the stricter tests set for taking account of non-financial factors are met. The Law Commission report does not assist trustees wishing to embrace the concept of 'responsible investment' in its fullest sense.

Next steps: recommendations of Law Commission

The Law Commission has not recommended any substantial changes to the law of fiduciary duties, concluding that the existing framework governing investment duties, adequately addresses the question of when ethical and ESG factors can and should be taken into account by trustees, and that codification would be a 'lengthy and laborious process which could have unintended consequences'.

The Law Commission does, however, make some minor recommendations for legislative changes that could be considered by the Government, as follows:

- to bring schemes with fewer than 100 members within the scope of reg 4 of the Investment Regulations;
- to require disclosures in the SIP to distinguish clearly between the trustee's use of financial and non-financial factors in investment policy. Currently the disclosure requirement relates to the extent to which 'social, environmental or ethical considerations' are taken into account when investing. The Law Commission notes this could lead to unhelpful confusion between the different roles played by ethical factors on the one hand and social and environmental and governance (ESG) type factors on the other, preferring that these two issues should be considered and disclosed under separate headings; and
- to require trustees to disclose their approach (if any) to stewardship activities (although it confirms that trustees should not be under any legal obligation to engage in such stewardship). This is a slightly odd recommendation in light of the existing requirement in reg 2(3)(c) that trustees disclose their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to their investments.

The provision of guidance is the solution suggested by the Law Commission to the legal uncertainty that arises from the complexity of the current law. The Law Commission itself addresses this need by providing a five-page guidance note summarising its conclusions for trustees. However, it suggests it would be more helpful still if tPR could endorse the Law Commission's conclusions and promulgate the Law Commission's guidance through a Code of Practice.

This would be a neat trick. The Law Commission cannot make definitive statements of what the law is. There is also, as discussed in this paper, scope for debate as to whether the tests set out by the Law Commission are actually supported by current case law. However, if tPR were to take up the recommendation and include the Law Commission's conclusions in a Code of Practice, then this may enable a court to take this into account if such questions were

to be subject to future judicial scrutiny.[38] As the Law Commission explains, 'this would strengthen the authority of the tests we have set out and ensure that they were considered in any subsequent court case'.

It remains to be seen whether tPR will issue a Code of Practice on this subject. However, if it does, we may find ethical and ESG investment issues starting to appear more frequently on the agendas of pension scheme trustees and, potentially, more questions being asked of us as advisers as to whether and how trustees can or should take account of such factors when investing.

38 Section 90 of the Pensions Act 2004 allows tPR to issue a Code of Practice 'containing practical guidance in relation to the exercise of functions under the pensions legislation' or 'regarding the standards of conduct and practice expected from those who exercise such functions'. Section 90(4) provides that 'a code of practice is admissible in evidence in any legal proceedings and, if any provision of such a code appears to the court or tribunal concerned to be relevant to any question arising in the proceedings, it must be taken into account in determining that question'. 'Pensions legislation' for these purposes would include the relevant provisions of the Pensions Act 1995 and the Investment Regulations. However, it is doubtful that tPR has any authority to issue a Code of Practice on the proper application of trust law duties.