International
Comparative
Legal Guides

Environmental, Social & Governance Law 2021

A practical cross-border insight into ESG law

First Edition

Featuring contributions from:

BAHR
Bowmans
Brown Rudnick LLP
Galicia Abogados, S.C.
Grimaldi Studio Legale
Haynes and Boone, LLP
Herbert Smith Freehills
Herbert Smith Freehills LLP
Herzog Fox & Neeman
Macfarlanes LLP
Mannheimer Swartling Advokatbyrå
Maples Group
Nagashima Ohno & Tsunematsu
Schellenberg Wittmer Ltd
Stikeman Elliott LLP
SustainAdvisory
Travers Smith LLP
Wachtell, Lipton, Rosen & Katz
Wolf Theiss

ICLG.com

Expert Chapters

1 **Moving Forward With ESG: Considerations for Boards and Management**
David M. Silk & Carmen X. W. Lu, Wachtell, Lipton, Rosen & Katz

7 **Incorporating Sustainability into Debt and Equity Financing**
Emma Russell, Emily Fuller & Deborah Low, Haynes and Boone, LLP

12 **ESG and UK Pension Schemes: Challenges and Opportunities**
Andy Lewis & Jonathan Gilmour, Travers Smith LLP

16 **ESG and Litigation: The Outlook for Shareholders and Listed Companies**
Ravi Nayer, Razzaq Ahmed & Tom McDonnell, Brown Rudnick LLP

28 **ESG and Corporate Strategy: A Cross-Sectoral View**
Rebecca Perlman, Silke Goldberg & Iria Calviño, Herbert Smith Freehills LLP

Q&A Chapters

34 **Australia**
Herbert Smith Freehills: Heidi Asten, Timothy Stutt & Jacqueline Wootton

43 **Austria**
Wolf Theiss: Sarah Wared, Florian Kusznier & Claus Schneider

48 **Canada**
Stikeman Elliott LLP: Vanessa Coiteux, Ramandeep K. Grewal & Catherine Grygar

57 **Ireland**
Maples Group: Peter Stapleton, Ronan Cremin & Jennifer Dobbyn

63 **Israel**
Herzog Fox & Neeman: Janet Levy Pahima, Liat Maidler & Daniel Kaczelnik

71 **Italy**
Grimaldi Studio Legale: Riccardo Sallustio
SustainAdvisory: Francesca Fraulo

79 **Japan**
Nagashima Ohno & Tsunematsu: Kiyoshi Honda

85 **Mexico**
Galicia Abogados, S.C.: Mariana Herrero, Maurice Berkman, Carlos Escoto & Lorena Kiehnle Barocio

92 **Norway**
BAHR: Svein Gerhard Simonnæs, Asle Aarbakke & Lene E. Nygård

97 **Poland**
Wolf Theiss: Marcin Rudnik & Joanna Gąsowski

104 **South Africa**
Bowmans: Ezra Davids & Ryan Kitcat

112 **Sweden**
Mannheimer Swartling Advokatbyrå:
Patrik Marcelius, Cecilia Björkwall & Joel Palm

119 **Switzerland**
Schellenberg Wittmer Ltd: Christoph Vonlanthen, Lorenzo Olgiati, Fabio Elsener & Giulia Marchettini

126 **United Kingdom**
Macfarlanes LLP: Tom Rose & Olivia Seeley

136 **USA**
Wachtell, Lipton, Rosen & Katz: David M. Silk & Carmen X. W. Lu

ESG and UK Pension Schemes: Challenges and Opportunities

Andy Lewis

Travers Smith LLP

Jonathan Gilmour

1 Introduction

ESG has surprisingly deep roots within UK occupational pensions, but recent years have seen a rapid acceleration of law, regulation and practice. This has been driven by an evolving combination of legislation, scientific guidance and commercial commentary alongside wider Government and societal expectations that, as institutional investors responsible for providing private individuals' retirement benefits, pension schemes ought to be deploying their capital to promote ESG objectives (or, at least, protecting that capital from adverse impacts caused by ESG risks).

This chapter discusses the complex and dynamic way ESG is emerging in the pensions law of England and Wales and outlines some possible considerations for pension scheme sponsors and managers. This chapter focuses primarily on ESG in pension scheme investment governance, because this is where the majority of legal developments as they affect UK occupational pension schemes have focused to date.

2 ESG and Investment: Economic Rationale and General Law

Case law in the 1980s and 1990s[1] highlighted an apparently fundamental tension between the duties of occupational pension scheme trustees to invest assets in order to fund pensions and other retirement benefits, and their ability to take ESG considerations into account when investing.

These debates have now largely been settled. Following two landmark Law Commission reports,[2] in very broad terms the orthodox legal view is that:

- ESG considerations can and probably should feature in pension scheme investment decision-making where they are "financially material" (i.e. relevant) to investment performance or risk; and
- ESG issues that are not "financially material", and wider non-financial considerations (such as political, ethical or philosophical beliefs), are known as "non-financial" factors. Additional legal tests must be met before non-financial factors may influence pension scheme investment decisions (discussed below).

In practice, this means the scope for ESG within a pension scheme's investment strategy will often depend upon identifying "financially material" ESG factors and integrating these into the scheme's investment decision-making. For these purposes, there is mounting economic evidence that ESG considerations are capable of being financially material. There is also evidence that ESG investments can be compatible with achieving desired risk-adjusted financial returns. An increasingly diverse range of ESG-themed investment products are coming to the market and we have seen a number of pension schemes starting to explore these. However, a full discussion of the economics is beyond the scope of this chapter.

3 Recent and Forthcoming Legal Developments

Investment policies and disclosures

Beyond the general law, specific ESG pensions legislation started coming into force in 2019. At the core are new requirements for ESG-related investment policies to be set out in pension schemes' Statements of Investment Principles (SIPs). In particular, it is now law that SIPs must include policies on:

- the integration of financially material considerations (including but not limited to ESG and climate change) into the investment strategy;
- how, if at all, non-financial factors are taken into account; and
- stewardship and engagement with investees and co-investors in relation to a non-exhaustive list of matters such as strategy and performance.

From 1 October 2020, the legal requirements are expanding again:

- stewardship material must be broadened to include the scheme's policies on engagement with other stakeholders and consideration of capital structures and conflicts of interest; and
- the SIP must either set out policies about the pension scheme's arrangements with asset managers or explain why there are no such policies.

Beyond the SIP, over a period starting from 1 October 2020, many pension schemes will need to include an "Implementation Statement" in their annual reports to track and explain progress against their SIP policies.

Finally, requirements to disclose SIPs and Implementation Statements on a publicly accessible website have started being phased in.

The rationale appears to be that the development and monitoring of policies, plus disclosure online, will allow greater scrutiny of pension schemes by beneficiaries, other market participants (such as investment specialists) and wider stakeholders such as NGOs; and this scrutiny may, in turn, gradually "level-up" standards of good practice across the industry. In other words, the legislation is "nudging" the industry towards ESG but not yet compelling particular forms of activity. This fits with the approach of some wider ESG-related initiatives

such as the Task Force on Climate-related Financial Disclosures (TCFD) and the UK Stewardship Code. However, it is a relatively novel approach in English pensions law.

Governance and risk systems

ESG governance laws are expanding, too. Statute already requires the UK Pensions Regulator to issue a Code of Practice which will cover, among other things, expectations around governance systems for considering (i) ESG matters in investment, and (ii) new or emerging ESG risks as part of the scheme's "own-risk" assessment.[3]

More significantly, the Pension Schemes Bill currently before the UK Parliament includes a wide power to introduce regulations "with a view to securing that there is effective governance of the scheme with respect to the effects of climate change", among other things. Despite some early industry criticism of the breadth of these provisions, a recent Government consultation appears to confirm that lawmakers intend to introduce new, wide-ranging obligations. The proposal is to bring TCFD principles into pensions law on a phased basis through new requirements around risk assessment, disclosure and express consideration of climate change targets, impacts and steps that may be taken by schemes in response. In our view, these proposals, if enacted, are likely to extend climate change considerations into new areas of scheme operations and communications, beyond the traditional pension investment space.

Subject to finalised Brexit terms, additional but separate disclosure obligations are also likely to arise from the EU Sustainable Finance Disclosure Regulation from March 2021.

4 ESG in Practice: Considerations and Challenges

Developing new and effective policies

In practice, the pensions industry has been prioritising reviews of existing pension scheme investment arrangements for areas that may fall short of the new ESG requirements. This is unsurprising: most pension scheme investment strategies have developed over time, evolving in line with contemporaneous thinking and the scheme's needs, whereas the new legislation requires something more – an overarching reappraisal of the position today through a specific ESG lens. Consequently, in our experience, it is not unusual to identify some ESG "gaps".

The effective dates of the legislation outlined above mean that new ESG policies could now need to be drawn up relatively quickly in order to fill any gaps. This may not be as easy as it sounds. Much of the drafting of the relevant legislation and official commentary is extremely broad and high level. This is helpful in giving pension schemes a wide discretion to comply in a way that suits their particular circumstances. The disadvantage is that the underlying legal requirements are vague in some respects, making it hard to know whether a proposed approach will be legally compliant: an example is the regulation applicable to asset manager policies, which is derived from a wider EU directive aimed at all institutional investors in listed equities and does not appear to be a natural fit for some typical UK pension investment structures.

The issues are compounded because, as outlined above, the law on ESG in pensions has been developing piecemeal. The result is a bewildering array of legislation, guidance and commentary from a variety of sources. Investment consultants and lawyers have an important role in helping pension schemes make sense of the material.

Non-financial factors

There are also ongoing questions about the scope for pension schemes to take non-financial factors into account in their investment decisions. Despite a Law Commission report (2014) and a recent UK Supreme Court decision,[4] there remains uncertainty about some specifics of the relevant legal test. A second limb of the legal test also requires there to be, in effect, a high demand for the integration of non-financial factors among scheme beneficiaries: this is a strict threshold which can be difficult to meet in all but the most clear-cut cases.

For defined contribution schemes where beneficiaries have facilities to select their own investments, there may be greater scope to offer purely ethical "self-select" investment options (discrimination laws protecting religious or philosophical beliefs may also influence the range of investment options made available). But for default investment options where beneficiaries are not required to make a choice, and for defined benefit schemes, the position needs extremely careful thought.

Are we (collectively) missing something?

Although ESG has risen rapidly up the pensions agenda, there have, in our view, also been some potentially significant silences in the debates so far. Two areas stand out in particular.

- **Governance**. Unlike environmental and some social factors, the "G" in ESG seems to have attracted less commentary in the pensions space when compared with ESG in other sectors such as corporates and financial products. Perhaps this is because many investors are already familiar with integrating certain governance factors into their investment decisions and have being doing so for a long time without the ESG label (examples include executive compensation and dual Chair-CEO appointments). However, numerous other governance factors exist or are emerging, and may be just as relevant. Diversity is a case in point: there is strong evidence that more diverse organisations make better decisions, leading to better performance, but there is comparatively less discussion of this as a factor when selecting investments or managers. Pension schemes themselves may also reflect whether their own internal diversity is contributing to effective decisions for their stakeholders.[5]
- **Employer covenant**. To maintain funding levels, most UK defined benefit pension schemes rely upon ongoing financial support from one or more sponsoring employers – the "employer covenant". ESG interacts with this in two main ways. First, integration of ESG into the scheme's investments may change the scheme's investment profile, which in turn could affect the scheme's liabilities and funding needs (and thus the employer covenant). Secondly, ESG considerations may directly or indirectly affect the employer's business and thus its ability to support the scheme – for example, if downside ESG risks such as climate change disruption crystallise in the business, or if a new ESG-related opportunity triggers a need for investment. There has been very little analysis of whether and, if so, how the legal and regulatory framework allows ESG to be integrated into employer covenant analysis in this way. This is something that we, as a firm, have been considering in collaboration with specialist covenant advisers.

5 Conclusions

ESG provides an opportunity to reassess UK pension scheme operations and risks in the light of some of the defining financial and societal issues of our time. However, as discussed above, the underlying legal position is complex.

Based on the current state of play, we conclude that (with some notable exceptions) the UK pensions industry is likely to take an iterative approach to ESG, starting tentatively and deploying increasingly sophisticated approaches over the medium term. This may not be the outcome policymakers were aiming for, but the present multiplicity of legal sources and lack of clear objective standards in some key areas could hinder the more rapid adoption of consistently high levels of compliance across the industry. Our hope is that more cohesive authorities will develop. Meanwhile, ESG is very likely to require significant voluntary engagement and proactivity across the industry. There are now clear signs that this is emerging.

Endnotes

1. Notably *Cowan v Scargill* [1984] 2 All ER 750 and *Harris v Church Commissioners* [1992] 1WLR 1241.
2. *The Fiduciary Duties of Investment Intermediaries* (2014) and *Pension Funds and Social Investment* (2017).
3. The draft Code of Practice is awaited.
4. *R (Palestine Solidarity Campaign Ltd and another) v Secretary of State for Housing, Communities and Local Government* [2020] UKSC 16.
5. In the occupational pensions context, see the article by another of our partners, Daniel Gerring, "Drawing on Diversity to Drive Better Decisions", *Pensions Aspects* (9 November 2018), and the Pension and Lifetime Savings Association Trustee Guide, *Diversity and Inclusion Made Simple*, co-authored with Travers Smith LLP (March 2020).

Andy Lewis is a partner in the Pensions Sector Group at Travers Smith, and the author of material on ESG and pensions on the firm's Sustainable Business hub. He has expertise across all areas of UK pensions law, helping businesses and trustees find effective ways to navigate this complex area. His regular work includes major pensions projects such as scheme reorganisations, liability management, funding settlements and corporate activity.

He is a member of the firm's LGBT+ Group and provides *pro bono* legal advice to the well-known LGBT+ charity, Just Like Us. He also volunteers at the City Law School Public Legal Advice Clinic and has provided *pro bono* legal advice on individual personal pension complaints.

Andy is Chair of the Communications Committee of the Association of Pension Lawyers. He is also a member of PLSA's Central London Group Committee.

Travers Smith LLP
10 Snow Hill
London EC1A 2AL
United Kingdom

Tel: +44 20 7295 3000
Email: andrew.lewis@traverssmith.com
URL: www.traverssmith.com

Jonathan Gilmour is a partner and head of the Derivatives & Structured Products Group at Travers Smith. His practice is both transactional and advisory. He is regarded by peers and clients as a leading specialist in his field, and as a champion of "buy-side" interests in the UK derivatives market. Jonathan's clients include some of the UK's largest and most sophisticated occupational pension schemes. His work includes advising evolving ESG and sustainability investment policies and horizon scanning in relation to ESG and sustainability regulations.

He is a member of the panel advising the Impact Investing Institute on a paper outlining the interaction between impact investment and the fiduciary duties of pension scheme trustees and a member of the Travers Smith Sustainability Taskforce, with responsibility alongside our pensions partner team for ESG requirements applicable in the pensions sector and sustainable finance initiatives.

Jonathan is involved with key industry associations, including his roles on the Association of Pension Lawyers' Investment & DC Committee, the Society of Pension Professionals' Defined Benefits Committee and the Pensions Management Institute's London Group Committee.

Travers Smith LLP
10 Snow Hill
London EC1A 2AL
United Kingdom

Tel: +44 20 7295 3000
Email: jonathan.gilmour@traverssmith.com
URL: www.traverssmith.com

Travers Smith is an international law firm, which acts for publicly listed and private companies, as well as other business enterprises including not-for-profit organisations.

We are a full-service law firm with 84 partners and over 400 lawyers based in the City of London. Over the years, we have nurtured a confident and collaborative approach to delivering excellence in an ever-changing legal landscape. As a result, we have carved a reputation for enterprising thinking and uncompromising quality.

www.traverssmith.com

TRAVERS SMITH

ICLG.com

Other titles in the ICLG series

Alternative Investment Funds
Anti-Money Laundering
Aviation Finance & Leasing
Aviation Law
Business Crime
Cartels & Leniency
Class & Group Actions
Competition Litigation
Construction & Engineering Law
Consumer Protection
Copyright
Corporate Governance
Corporate Immigration
Corporate Investigations
Corporate Tax
Cybersecurity
Data Protection
Derivatives
Designs
Digital Business
Digital Health
Drug & Medical Device Litigation
Employment & Labour Law
Enforcement of Foreign Judgments
Environment & Climate Change Law
Family Law
Fintech
Foreign Direct Investment Regimes
Franchise
Gambling
Insurance & Reinsurance
International Arbitration
Investor-State Arbitration
Lending & Secured Finance
Litigation & Dispute Resolution
Merger Control
Mergers & Acquisitions
Mining Law
Oil & Gas Regulation
Outsourcing
Patents
Pharmaceutical Advertising
Private Client
Private Equity
Product Liability
Project Finance
Public Investment Funds
Public Procurement
Real Estate
Renewable Energy
Restructuring & Insolvency
Sanctions
Securitisation
Shipping Law
Telecoms, Media & Internet
Trade Marks
Vertical Agreements and Dominant Firms

@ICLG_GLG

The International Comparative Legal Guides are published by: glg global legal group