Sustainable Investing by Occupational Pension Scheme Trustees: Reframing the Fiduciary Duty

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Introduction

A variety of legislative, policy, scientific, commercial and stakeholder influences prompt occupational pension scheme trustees to factor environmental, social and governance (ESG) risks and opportunities, and potentially wider sustainability considerations such as impact, into their investment decisions. However, a trustee's ability to do this in practice typically depends on a close interaction between two major issues. The first is the investment reality: the extent to which sustainability considerations are expected to affect investment risk, opportunity and strategy. The second issue is the law around trustee investment decision-making, and specifically the extent to which the law permits sustainability considerations to be taken into account in trustee investment decisions.

Where the views on these two issues are aligned, trustees are more likely to be able to get comfortable in justifying investment decisions that factor in sustainability considerations, such as adopting net zero targets or allocating assets to ESG or impact funds. There are examples of schemes having taken such decisions in the real world today.[1] By contrast where views are not aligned, such decisions can become difficult or impossible to support.

In that context, it is significant that there remains something of a vexed question around the extent to which sustainability considerations are compatible with the trustee fiduciary duty when investing. A recent survey reported in *Professional Pensions* revealed mixed views about whether ESG 'compromises' the fiduciary duty.[2] In its response to a government consultation on climate change and stewardship disclosures, the Impact Investing Institute expressed 'significant ongoing concern about misconceptions and misapplications of the fiduciary duty,

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1 For example, the largest private-sector pension scheme in the UK, the BT Pension Scheme, adopted a net zero target in 2020.

2 William-Smith, H, 'Compromising on fiduciary duty? Your thoughts on ESG', Professional Pensions, 8 June 2022, www.professionalpensions.com/news/4050905/compromising-fiduciary-duty-esg, accessed 21 September 2022. See also Westley, A, 'The S Factor: a challenge to fiduciary duty', Professional Pensions 17 May 2022, www.professionalpensions.com/opinion/4049836/%E2%80%98%E2%80%99-factor-challenge-fiduciary-duty, accessed 21 September 2022, in which the author observes: 'Time and again, trustees cite their fiduciary duty as a reason for hesitancy in engaging with ESG in scheme investments.'

with the result that sustainable investment practices are not being effectively cultivated.'[3] In this author's practice, this is often described to him as 'uncertainty' about the fiduciary duty.

This article seeks to explore the sources of uncertainty within the current orthodox legal interpretation of the fiduciary duty in the occupational pensions context. It then attempts to outline a reframed understanding of the fiduciary duty which may help to address those uncertainties.

This article therefore focuses on the case law and well-known Law Commission analysis of the fiduciary duty. Save for a minor digression later in the discussion, it does not cover the other significant sources of occupational pension scheme investment duties, ie the provisions of the scheme's governing trust deed and rules, and primary and secondary legislation.

Law Commission model

A useful starting point is provided by two landmark Law Commission reports: 'The Fiduciary Duties of Investment Intermediaries' (LC2014)[4] and 'Pension Funds and Social Investment' (LC2017).[5]

It should be noted that the Law Commission's ability to give definitive statements of the law has been questioned.[6] The Law Commission itself also made clear that its remit in this area was to evaluate the state of the law, make recommendations for possible action by other authorities and 'explain the nature of fiduciary and other duties to act in the best interests of savers'.[7] Despite these limitations, the author's experience is that the conceptual model of the fiduciary duty developed by the Law Commission in its two reports has been, and continues to be, influential in shaping legal, regulatory and industry thinking notwithstanding developments in the case law and investment practice since LC2014.[8] It therefore makes sense for a discussion of the law in this area to engage with the Law Commission model.

In a key passage from LC2014, the Law Commission summarises the basic position as follows:

> The primary concern of trustees must be to generate risk-adjusted returns. In doing so, they should take into account factors which are financially material to the performance of an investment. These may include environmental, social and governance factors. It is for trustees, acting on proper advice, to evaluate and weigh these risks.

3 'The Impact Investing Institute's response to the Department for Work and Pensions Consultation: Climate and investment reporting: setting expectations and empowering savers', 6 January 2022, www.impactinvest.org.uk/wp-content/uploads/2022/01/DWP-Consultation-Response-.pdf, accessed 21 September 2022.

4 https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/03/lc350_fiduciary_duties.pdf, accessed 21 September 2022.

5 https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2017/06/Final-report-Pension-funds-and-socia....pdf, accessed 21 September 2022.

6 Daykin, S, '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?' (2014) 28(4) TLI 165 at 189.

7 LC2014, p 9.

8 For examples of the influence of LC2014, see *Palestine Solidarity Campaign v Secretary of State for Housing, Communities and Local Government* [2020] UKSC 16, reg 2(3)(b)(vi)–(vii) of the Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378), the Impact Investing Institute, 'Impacting investing by pension funds: fiduciary duty – the legal context' (November 2020): www.impactinvest.org.uk/wp-content/uploads/2020/11/Impact-investing-by-pension-funds-Fiduciary-duty-%E2%80%93-the-legal-context.pdf accessed 21 September 2022, and 'Investing to fund DB' in the Pensions Regulator's DB Investment Guidance: www.thepensionsregulator.gov.uk/en/document-library/scheme-management-detailed-guidance/funding-and-investment-detailed-guidance/db-investment/investing-to-fund-db#:~:text=While%20non%2Dfinancial%20factors%20are,share%20a%20particular%20view%2C%20and, accessed 21 September 2022.

> However, the law is flexible enough to accommodate other concerns. Trustees may take account of non-financial factors if they have a good reason to think that the scheme members share a particular view, and their decision does not risk significant financial detriment to the fund.[9]

Thus, in broad terms, the Law Commission recognises two categories of factor that may influence trustees when exercising the power of investment:

(a) 'non-financial factors'; and
(b) 'financial' (or 'financially material') factors.

These categories will be considered in turn. As will be seen, sustainability considerations can potentially fall into either category.

Non-financial factors

Definition and scope

Non-financial factors are defined as 'factors which might influence investment decisions motivated by other (non-financial) concerns, such as improving members' quality of life or showing disapproval of certain industries.' So, non-financial factors are drivers of investment decisions that are not motivated by what might be called conventional investment concerns, such as risk/return.

Against that backdrop, the Law Commission concluded that trustees may take non-financial factors into account subject to two threshold tests:

(a) trustees should have good reason to think that scheme members would share the concern; and
(b) the decision should not involve a risk of significant financial detriment to the fund.[10]

The Law Commission also said that, whilst trustees can consider issues in the round when deciding whether or not the two threshold tests are met, both tests need to be met in order for an investment decision to be made on non-financial grounds.[11]

For occupational pension scheme trustees, the non-financial factors category gives rise to a number of potential issues.

Legal uncertainty

First, there remains a very real question about whether the non-financial factors category is a correct statement of the law in the occupational pension scheme context.[12] This assertion is perhaps surprising: after all, the non-financial factors category has now received specific judicial recognition.

9 LC2014, p 127.
10 Save where the investment is specifically authorised by the fund's trust deed or is a defined contribution self-select fund – *Ibid*, pp 113–114.
11 *Ibid*, p 123.
12 See Daykin, S (above n 6), pp 179–180.

In *Palestine Solidarity Campaign v Secretary of State for Housing, Communities and Local Government*, Lord Carnwath observed: 'There appears now to be general acceptance that the criteria proposed by the Law Commission are lawful and appropriate.'[13] This seems to be a clear endorsement. Moreover, on its face *Palestine Solidarity* is a case about pension fund investment: the underlying practical issue in the case was, in effect, a disagreement about whether the scheme should adopt ethical investment criteria to screen against certain Israeli-related investments (a policy which the Palestine Solidarity group supported). So where is the issue from an occupational pensions perspective?

To begin with, the schemes concerned in the *Palestine Solidarity* case were not private sector occupational pension trusts: they were public sector schemes constituted under secondary legislation and subject to a separate (albeit similar) set of investment duties. More importantly, however, in substance *Palestine Solidarity* was not a decision about the basic investment duties at all. It was a judicial review of the scope of the Secretary of State's statutory power to issue investment guidance to the relevant public sector schemes. The guidance issued by the Secretary of State appeared to be largely based on the Law Commission's model for describing the investment duties, including by reference to non-financial factors, but the central issue in the proceedings was that it sought to prohibit the relevant public sector schemes from adopting investment policies that were contrary to UK foreign or defence policy. Since regulations required the public sector scheme to construct its investment strategy in accordance with the guidance, the practical effect of the revised guidance would have been to prevent the schemes from applying their proposed ethical investment criterion (based on non-financial factors) to screen against the relevant Israeli-related investments. The immediate question before the Supreme Court was not, therefore, what the fundamental scope of the investment duty was, but rather whether the Secretary of State had exceeded their statutory powers in issuing the guidance on the specific terms that they did. The Supreme Court decided that the relevant guidance was *ultra vires* the statute.

Viewing the judgment in that way, Lord Carnwath's observations about the Law Commission's non-financial factors test were *obiter*. The same can be said about the references to non-financial factors in the judgments of Lord Wilson (agreed by Lady Hale) and the dissenting judgment of Lady Arden and Lord Sales.[14] Thus, it is suggested, *Palestine Solidarity* does not in fact move the non-financial factors debate materially further forward for occupational pension schemes.

The question arose again more recently in *Butler-Sloss & ors v the Charity Commission of England and Wales & anor*.[15] In this case, Michael Green J considered proposed trustee investment policies motivated by climate change concerns whereby investments that were not aligned with the 2016 Paris Agreement would be screened, even if this could produce lower overall returns in the portfolio. The learned judge specifically considered the extent to which 'non-financial' considerations, such as a principled desire to mitigate climate change, could lawfully be taken into account when exercising these trusts' investment powers.[16]

13 *Palestine Solidarity*,(above n 8), at [43]. The 'significant financial detriment' limb of the non-financial factors test is described slightly differently here: it is cited as 'not involve significant risk of financial detriment'. By contrast, the test in both LC2014 and in the relevant LGPS guidance was 'not involve a risk of significant financial detriment' – this latter formulation being derived from another leading case: *Harries (Bishop of Oxford) v Church Commissioners* [1993] 2 All ER 300 at [16]. The difference in language has been highlighted as a further source of uncertainty about the effect of *Palestine Solidarity*, though viewed in context of the judgment as a whole, it seems more likely to the author that this was a simple slip of the pen. See also Bennett, P, 'Would it be a breach of a pension fund trustee's investment duties to invest in "green gilts"'? (2021) 35 TLI 133.

14 *Harries (Bishop of Oxford)* (above n 13), at [17]–[19], [24]–[27], [57], [60], [62] and [80].

15 [2022] EWHC 974 (Ch).

16 *Ibid,* at [78].

However, in *Butler-Sloss*, the Court was looking at investment policies of charitable trusts that had express environmental protection purposes.[17] In that context, it is perhaps easier to see how the Court concluded that a principles-motivated net zero-aligned investment policy would be proper. As will be seen below, occupational pension schemes do not have this sort of express environmental protection purpose. Moreover, this case was argued against a backdrop of specific guidance from the Charity Commission, and the leading case in this area, both of which considered questions of the extent to which *charities* can decide to make ethical investments.[18] Occupational pension schemes are not charitable trusts, and Michael Green J is careful to note this distinction in his review of the leading occupational pensions investment case:

> In *Cowan v Scargill* [1985] 1 Ch 270, Sir Robert Megarry V-C had to consider whether the trustees of the Mineworkers Pension Scheme, half of whom were appointed by the National Union of Mineworkers … were acting in breach of their duties in blocking an investment plan which included an increase in overseas investment and investments in energy companies that were in direct competition with coal. Such investments would be contrary to the NUM's policy and principles. This was a trust for the provision of financial benefits, not for a financial purpose. As such, the Vice-Chancellor held that as this was a trust to provide financial benefits, the power of investment must be exercised to yield the best return for beneficiaries.[19]

We will return to *Cowan v Scargill* later. The key point for present purposes is that the factual matrix in *Butler-Sloss* makes the case difficult to rely on as authority for the position in relation to non-financial factors for private sector occupational pension schemes, meaning that between this case and *Palestine Solidarity*, there is still no decided authority on the position.

Practical uncertainties

Even if the legal uncertainty around non-financial factors for occupational pension scheme trustees did not exist, there are also practical uncertainties within the two threshold tests themselves.

(a) *'Good reason to think members would share the concern'* How should trustees properly satisfy themselves on this point? The Law Commission comments on this in LC2014 and in accompanying guidance. On the one hand, unanimity of views is not required. On the other, trustees should not simply impose their own ethical views. In clear-cut cases, it may be sufficient to assume what members believe. In others, consultation may be appropriate.[20] This is helpful up to a point but attempts to build real-life decisions upon this foundation soon reveal other layers of potential difficulty. For example, is it sufficient only to seek the views of members as the primary beneficiaries of the

17 *Ibid,* at [13]–[14].

18 Charity Commission, 'Charities and investment matters: a guide for trustees (CC14)', www.gov.uk/government/publications/charities-and-investment-matters-a-guide-for-trustees-cc14, accessed 21 September 2022, and *Harries (Bishop of Oxford) v Church Commissioners* [1993] are discussed at *Butler-Sloss & ors v the Charity Commission of England and Wales & anor* (above n 15), [35]–[76].

19 *Butler-Sloss & ors v the Charity Commission of England and Wales & anor* (above n 15), at [52].

20 LC2014, pp 119–121; LC2017, pp 41–42 and Ch 9.

scheme (but not spouses or other contingent beneficiaries)?[21] Why are the chosen non-financial concerns being prioritised over others? What level of apparent consensus is appropriate within the particular scheme membership? Do members' views need to be 'fully informed' or similar – and who is responsible for providing the information to members if this is required? What happens if members' views change over time or new and more pressing non-financial concerns emerge – might the investments need to be rebalanced? How to guard against the risk of the decision being swayed one way or the other by a vocal minority? Are trustees confident in communicating that there could be some financial detriment to members' retirement benefits? How in practice should trustees deal with members who feel disenfranchised? How much time and resource should trustees properly invest in this exercise, given that there is no positive duty on them to take non-financial factors into account in the first place?

(b) *'Not involve risk of significant financial detriment to the fund'* What level of financial detriment to the scheme is 'significant'?[22] What is the benchmark against which the risk of financial detriment, and the acceptable (or non-significant) level of potential detriment should be assessed, especially if there is no directly comparable investment or strategy? The test seems to require trustees to prove a negative (the absence of risk), and with a higher degree of confidence than is required when investing for 'financially material' reasons.[23] There is less guidance on these issues, beyond a clear steer for the need for professional advice and a need to consider each issue on its merits instead of applying a blanket policy.[24] In my view, it is highly likely to require a nuanced analysis of the scheme's specific characteristics – its benefit structure, the overall construction of its investment strategy, its investment time horizons and member demographics.

These practical uncertainties are not easy to resolve, and trustees would need a good evidence trail of thoroughly considered decision-making on both points in order to give them the greatest confidence in their position in the event of a future challenge. There are some further thoughts on this below but note that robust decision-making on these issues can make for unwieldy and expensive governance, which in turn could act to discourage trustees and their advisers from exploring the issues (on grounds of cost effectiveness if nothing else).

Conclusions on non-financial factors

There are some genuine legal and practical uncertainties around the ability of occupational pension scheme trustees to take non-financial factors into account in investment decision-making.

21 This limb of the LC2014 test was perhaps extrapolated from an aspect of Sir Robert Megarry VC's judgment in *Cowan v Scargill* [1985] Ch 270 – see [48]. For more on the position of spouses and contingent beneficiaries, see Pollard, D, *The Law of Pension Trusts* (Oxford University Press, 2013), Ch 8. Note that the test proposed in LC2014 does not mention the views of the sponsoring employer (which effectively underwrites the investment strategy in a defined benefit scheme) – though of course trustees who are required to produce a statement of investment principles must include within this their policy on 'non-financial matters', and there is a requirement to consult (properly) with the employer about the statement of investment principles: see reg 2(2)(b) of the Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378) and *Pitmans Trustees Ltd & ors v Telecommunications Group PLC* [2004] EWHC 181 (Ch).

22 And, indeed, what precisely is the test? See n 14 above.

23 Where a trustee invests in the best financial interests of beneficiaries, ie solely on the basis of financially material factors, there seems to be no express expectation in case law that the trustee must avoid all risk of financial detriment, or indeed the risk of significant financial detriment, as long as the duty of care is discharged. Discussed further below.

24 LC2014, pp 121–123.

For policymakers, private individuals, NGOs and others who are keen to see pension scheme capital deployed in a more sustainable or positively impactful way, this uncertainty causes a problem: it can lead to caution, even reluctance, on the part of trustees and their advisers, to invest in ways that might be characterised as involving non-financial factors. But this hesitancy can sometimes reflect an unspoken assumption that a sustainable or impactful investment consideration will always fall into the non-financial factors category. As demonstrated below, this assumption is not necessarily correct.

Financially material factors

Definition and scope

The Law Commission's second category of factor in trustee investment decisions is the 'financial factor'. Financial factors are defined variously within LC2014 as 'factors relevant to increasing returns or reducing risks', or 'any factor which is relevant to trustees' primary investment duty of balancing returns against risks.'[25] This choice of language is significant, as will be seen later below. For the moment, it is sufficient to note that the category encompasses those investment considerations that relate to the more traditional financially motivated investment drivers of risk and return – which non-financial factors expressly do not.

The Law Commission also gives a brief example to illustrate how ESG or ethical considerations might fall into the 'financial factors' category when making investment decisions:

> When investing in long-term equities, the risks will include risks to the long-term sustainability of a company's performance. These may arise from a wide range of factors, including poor governance or environmental degradation, or the risks to a company's reputation arising from the way it treats its customers, suppliers or employees. A company with a poor safety record, or which makes defective products, or which indulges in sharp practices also faces possible risks of legal or regulatory action.
>
> Often these risks will involve breaches of prevailing ethical standards. However, where poor business ethics raise questions about a company's long-term sustainability, we would classify them as a financial factor, rather than … a 'purely ethical' concern.[26]

Thus, the Law Commission draws a link between an ESG or ethical issue and the impact that issue has or may have on the financial risk within a business as an investee. The Law Commission is also at pains to point out that this does not mean that ESG or ethical considerations should always be taken into account as financial factors. Trustees have a discretion to ('may') take account of financial factors, but 'should' take into account those financial factors which are 'financially material'. And whether a particular ESG or ethical consideration is financially material is a question to consider in the context of the risks of a particular investment:

> It is for trustees' discretion, acting on proper advice, to evaluate these risks. This will include an assessment of which factors are financially material and the weight they should be given.[27]

25 *Ibid*, p 112.
26 *Ibid*.
27 LC2014, p 113.

In other words, based on the Law Commission model, ESG or ethical considerations are in theory capable of being financial factors where they have a bearing on the risk/return characteristics of an investment. And a financial factor becomes a financially material factor where the trustees, acting properly, decide that it is financially material to the decision they are making. Once this has occurred, trustees are under a positive duty to take that financially material factor into account as part of a legally proper decision-making process.

Areas of uncertainty

This apparently simple idea masks some further uncertainty. It is not the same kind of uncertainty as that which plagues the non-financial factors category (see above). Rather, it is suggested, this type of uncertainty is uncertainty arising from how to apply the financial (financially material) category within the intellectual exercise of making a trustee investment decision.

This uncertainty of application arises primarily because it appears that the Law Commission viewed the 'financial (financially material)' and 'non-financial' categories as mutually exclusive: a factor cannot not be both at the same time.[28] If a factor is financial, it may be taken into account. If it is a financially material factor, it 'should' be taken into account. If a factor is neither financial nor financially material nor passes the two-limb non-financial factor test, it is suggested that the Law Commission model expects the factor to be disregarded. Thus, the model requires trustees to carry out a four-way categorisation exercise, drawing bright lines between:

(a) those financial factors which they have identified as financially material (and which they are thus positively required to take into account);
(b) other financial factors which they may take into account by exercising their discretion as to how they construct their decision;[29]
(c) non-financial factors which can be taken into account because the two-stage Law Commission test is met; and
(d) factors which cannot properly be taken into account at all.

In real life, decisions are rarely so clear-cut. Consider a snapshot review of a business with potential issues around poor treatment of its employees. At the point of deciding whether or not to invest, this concern might be categorised as any of a financial or financially material or a non-financial factor – that is, as both an investment risk of varying degrees of likelihood and financial impact (labour relations deteriorating and/or litigation or regulatory interventions arising with an adverse effect on financial performance) and/or as a concern about the societal impact of the business (poor employment practices affecting employees' quality of life and the wider community). The factor might also switch categories over time – as the Law Commission's own example highlights, the concern might start out as a purely non-financial issue (poor business ethics) but later on crystallise an actual liability risk that clearly is financially material.

28 *Ibid*, p 112 – the Law Commission defines financial factors as those relevant to increasing returns or reducing risks, whereas non-financial factors 'are not'.

29 This does not require trustees to identify and consider every conceivable relevant factor – see below and Pollard, D, *Pensions, contracts and trusts: legal issues on decision making*, (Bloomsbury Professional, 2020), Chs 48–49.

So, in reality, the borders between financial, financially material and non-financial factors are mutable.

To address this, the Law Commission highlights the helpfully wide discretion that the law provides in allowing trustees to make judgment calls about what is or isn't financially material, and how much weight to give a particular financially material factor, within their overall decision (see above). On its face this is a sound legal workaround, and we will return to it from a slightly different perspective later. But this flexibility can, it is suggested, lead to difficulty for trustees in applying the Law Commission model when taking decisions in practice.

This is because, as was seen above, the Law Commission model requires sustainability considerations to be categorised as 'financial', 'financially material', 'non-financial but valid' or none of the foregoing. As has also been seen, whether or not a particular issue falls into the financial or financially material category can be highly context-specific and can change from time to time. The combined effect of (i) the existence of the four alternative but mutually exclusive categories, and (ii) the mutability of the boundaries between them, is to contribute further significant conceptual uncertainty into an already complex decision-making process. To be clear, this is a structural challenge within the model itself, and it is only a partial answer to say that trustees can take advice and seek to reach the best decision they can by applying objective criteria at the time they are making it. In the author's experience, a more likely result is higher levels of caution between trustees and their advisers about integrating sustainability considerations at all. This lies at the root of what the Impact Investing Institute described as the failure to cultivate more sustainable investment practices.[30] Others have described the categorisation problem in even stronger terms.[31]

Even if trustees are comfortable to categorise an issue as financial or financially material, they have to grapple with the further problem that the issue they are looking at could play out in complicated ways over an extended period of time and can crystallise unpredictably within investment performance or value. This makes the investment analysis underpinning the identification and evaluation of financial or financially material sustainability factors extremely complex and demanding. Trustees and their advisers need to be equipped to judge where, when, and how they think the relevant risks may arise. Data and conceptual frameworks are being developed that allow increasingly sophisticated analysis in this area and investment professionals are better placed to comment on this than this author,[32] but this idea is revisited below.

30 See n 3 above.

31 In a joint response to a Law Commission consultation on its programme of law reform, the Institute and Faculty of Actuaries and the Investment Consultants' Sustainability Working Group described the financially material/non-financial divide as a 'false dichotomy'. See www.actuaries.org.uk/system/files/field/document/07-31-Law-Commission-14th-Programme-of-Review.pdf, accessed 21 September 2022. As set out above, there are in fact three categories of valid factor within the Law Commission model: financial, financially material (which is a subset of financial where a positive duty to take the factor into account applies) and non-financial. While the distinction between financial and financially material factors should not be ignored, in practice, it is the dichotomy between financial (financially material) and non-financial factors which is likely to cause the greatest difficulty in decision-making.

32 For example note the discussions of pension funds as universal owners or quasi-universal owners: see Urwin, R, 'Pension funds as universal owners: opportunity beckons and leadership calls', *Rotman International Journal of Pension Management* (2011) 4(1), pp 26–33, and the number of organisations either voluntarily or compulsorily making disclosures in line with the recommendations of the Taskforce on Climate Related Financial Disclosures in the TCFD's regular status reports, 2021 here: https://assets.bbhub.io/company/sites/60/2022/03/GPP_TCFD_Status_Report_2021_Book_v17.pdf , accessed 5 October 2022.

Returning to the Law Commission equity investment example for a moment, though, a further key point is that it focusses on the financial risk of a single sustainability issue to a single company. Clearly, this may not be material to a pension scheme as an institutional investor. Trustees need to consider the issues in relation to the other types of pension scheme investment product and asset class they may more typically use, and to look across the scheme's portfolio as a whole in order to make decisions about sustainability issues at the investment strategy level. Thus, in practice, the concept of financial and financially material factors has to be scaled up from the Law Commission's example and painted onto a much broader canvas. This point is increasingly being recognised and is reflected, for example, in the greater focus on asset classes other than equities in the 2020 revision of the UK Stewardship Code.[33] All the while, of course, trustees and their advisers may also be taking care not to stray into non-financial territory.

Conclusions on financial and financially material factors

It is difficult to take issue with the basic legal reasoning underlying the 'financial (financially material)' concept, which, as we will see, is essentially that trustees should seek to identify and take account of factors that are relevant to the exercise of the investment power. This category is, potentially, extremely flexible. However, the challenge is identifying and defining what constitutes financial or financially material in a particular context, when a particular factor falls into a category, and when it does not. The problem is compounded when investments become more complex and are considered strategically over the time over which they are held and the investment time horizons of the scheme.

The next section will suggest how, by rediscovering the core legal analysis underpinning the concept of financial (financially material) factors, and some other perhaps less widely discussed points from the Law Commission's work, practitioners may be able to move beyond the tricky categorisation problems outlined above and towards a new and wider perspective on the fiduciary duty.

Towards a new perspective

Starting point

It might be helpful to begin our reappraisal at the very beginning.

In England and Wales, occupational pension schemes are purpose trusts. Their purpose is to provide the stated retirement benefits.[34] It is important to note that in contrast to some of the trusts considered in the authorities on non-financial factors above, occupational pension schemes rarely, if ever, have wider purposes such as environmental protection or the social or economic improvement, and in some cases may even expressly exclude these.[35]

33 For example see Principle in the UK Stewardship Code (2020), p 15, www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final-Corrected.pdf, accessed 21 September 2022.

34 Potentially by reference to 'acceptable cost to the employer' or similar: see Pollard, D, *The Law of Pension Trusts* (Oxford University Press, 2013), p 171. However, see also 'Redefining purpose' below.

35 For example, the trust deed of the Airways Pension Scheme expressly restricted the scope for making 'benevolent or compassionate' payments of a gratuitous kind that were not pension benefits in accordance with the scheme provisions – see *British Airways plc v Airways Pension Scheme Trustee Ltd* [2018] EWCA Civ 1533. Note that in that case, whilst one of the employer's arguments was that the trustee's actions fell foul of this 'benevolence' restriction, the Court of Appeal ultimately found that the trustee's actions failed the proper purposes test on different grounds.

It is said that any trustee's primary duty is to 'promote' the purpose for which the trust was established.[36] To this end, an occupational pension scheme's trust deed and rules confers certain powers and discretions upon the trustees. The power of investment is one such power. How, then, should that power be exercised?

Best interests and proper purpose

The most famous case on occupational pension scheme investment suggested that a trustee's key duty when exercising the investment power is to act in members' best (financial) interests. In *Cowan v Scargill*, Megarry VC held:

> The starting point is the duty of trustees to exercise their powers in the best interests of the present and future beneficiaries of the trust, holding the scales impartially between different classes of beneficiaries. This duty of the trustees towards their beneficiaries is paramount. They must, of course, obey the law; but subject to that, they must put the interests of their beneficiaries first. When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests. In the case of a power of investment, as in the present case, the power must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risks of the investments in question; and the prospects of the yield of income and capital appreciation both have to be considered in judging the return from the investment.[37]

This decision has been criticised.[38] The Law Commission observed that it has been the subject of 'great debate', noting that the references to yielding the best return for the beneficiaries have been interpreted in some quarters as imposing a duty on trustees to seek maximum returns.[39] The Law Commission dismissed the 'maximise returns' interpretation, and pointed to external sources suggesting this was not Megarry VC's intended meaning. It is suggested that any close reading of the judgment, in particular the full passage at paragraphs [41]–[52] in its context, supports this, and makes clear that the case is no authority for the 'maximise returns' approach at all. At most, it describes a duty to act in members' best financial interests (whatever those are).

The law has moved on since 1984, and the more orthodox view of this duty today is that the trustees must exercise the investment power for its proper purpose: that is, the purpose for which it was conferred upon them and not for any other or collateral purposes. The Law Commission described this as follows: 'A trustee should start with the trust deed and ask: what is the purpose of the power I have been given, and how can I use the power to promote that purpose?'[40] This interpretation is consistent with a long line of case law

36 LC2014, p 109, *Re Courage Group Pension Scheme* [1987] All ER 528 at 538, Pollard, D, *The Law of Pension Trusts*, (n 34 above), pp 169–175 and Pollard, D, *Pensions, contracts and trusts: legal issues on decision making*, (n 29 above), Pts 4 and 5, and Hayton, D, Matthews, P and Mitchell, C (Eds), *Underhill and Hayton: the Law of Trusts and Trustees* (Lexis Nexis, 2010), p 881.

37 [1985] Ch 270 at [41].

38 See, for example, Daykin, S (above n 6), 173 and the UNEP report authored by Freshfields Bruckhaus Deringer, 'A legal framework for the integration of environmental, social and governance issues into institutional investment' (October 2005), p 9, www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf, accessed 21 September 2022.

39 LC2014, p 72.

40 *Ibid*, p 109.

concerning other trustee powers.[41] To reconcile this concept with the idea of best (financial) interests from *Cowan v Scargill*, it is helpful to look at *Merchant Navy Ratings Pension Fund Trustees Limited v Stena Line and others,*[42] which concerned the propriety of the trustee's use of a power of amendment to introduce a new scheme funding regime. This case seems generally to have been accepted as clarification that the 'best interests' formulation is, in effect, a gloss on the core trustee duty to promote the purposes of their trust and to use their powers for the purposes for which they were conferred. Best interests and proper purpose are different sides of the same coin.

Since the core duty is best understood as focussing on proper purpose, the next question is what the purpose of the investment power actually is.

The Law Commission described it thus: 'The primary purpose of the investment power given to pension trustees is to secure the best realistic return over the long-term, given the need to control for risks.' There two aspects of this statement that are worth focussing on.

First, it is important to note that, having ruled out a duty to 'maximise' financial returns, the Law Commission also ruled out a duty framed around achieving 'reasonable' returns, or similar.[43] So clearly, when talking about 'best realistic return', the Law Commission envisages that there is an optimal risk-adjusted returns standard that trustees should be aiming for in order to exercise the investment power for its proper purpose.

Secondly, the analysis encapsulated in the Law Commission's formulation is easy to follow from a strict theoretical pensions law perspective. But as a definition of the purpose of the investment power, it is not free from difficulties in practice. Above all, a literal reading of the phrase 'best realistic return over the long-term, given the need to control for risks' can tend to reduce investment considerations to binary comparison of the risk and return characteristics of 'specified investment A' versus 'specified investment B'. Perhaps this approach was intended in part as a direct response to *Cowan v Scargill* and some of the misapprehensions about that case and the 'maximise returns' idea.[44] Unfortunately, the reference to 'best realistic return' may not have closed the door as firmly on these misapprehensions as the Law Commission might have wished. The language still allows the narrow comparative approach, and this narrower formulation of the purpose of the investment power has a number of challenges:

(a) It makes no express reference at all to the fundamental reasons why trustees should seek risk-adjusted financial returns in the first place. It implies that achieving the best realistic risk-adjusted returns is the end goal in itself.
(b) The phrase is brief and so does not expressly capture the wider context of the scheme's portfolio within which the specific investments may be held, where risks and returns are likely to be diversified across the whole portfolio. This has to be read in.
(c) It makes no reference to time horizons other than a long-term time horizon. The long-term may not be the time horizon driving the particular investment decision in question.

41 See, for example, *Re Courage Group Pension Schemes* [1987] 1 All ER 528 at 536 (Millet J), *Hillsdown Holdings v Pensions Ombudsman* [1997] 1 All ER 862 at 879 and 880 (Knox J) and *Edge v Pensions Ombudsman* [2000] Ch 602 at [50] (Chadwick LJ). For further discussion see Pollard, D, *The Law of Pension Trusts* (above, n 34), Ch 9.

42 [2015] EWHC 448 (Ch) at [228]–[229] (Asplin J).

43 LC2014, pp 95, 112, 128.

44 On its facts the investment decision in *Cowan v Scargill* was a more clear-cut comparative exercise, posing a choice between investing in UK coal or in coal overseas. The case implied that if an 'ethical' or non-financially motivated investment strategy could be expected to be equally beneficial as a comparable financially motivated strategy, there would be no impediment to adopting it – an idea which seems to lie at the root of much of the subsequent debate.

(d) It assumes there is an alternative investment product (or investment strategy) which is available and which can readily be compared against 'investment A'. In fact, this is likely to be difficult or impossible to establish as part of a practical decision-making exercise. One example of this is the well-known thought experiment which challenges whether trustees can properly invest in green gilts at a 'greenium' when an alternative cheaper 'standard' gilt is also available which is expected to provide a similar return for the same level of credit risk.[45] Where is the best realistic risk-adjusted return in this scenario? Some argue that the proper answer is to choose the brown gilt. In reality, there are arguments that on closer examination, green gilts and standard gilts are not as directly comparable as the example implies. [46] If that is right, the comparative approach is potentially conceptually flawed.

Thus, it is suggested, we need to look again at how we define the proper purpose of the investment power.

Redefining purpose

A learned judge has warned against setting out propositions that are too general and 'shorn of the context of a particular scheme.'[47] Any sort of exercise to clarify the proper purpose of the investment power in a new definition is, of course, likely to need significant further work. Having said that, it is suggested there because there are 'gaps' in the LC2014 formulation, as outlined above, this exercise could be worthwhile. It is also tentatively suggested that one way to address the gaps might be to look at defining the purpose of the investment power in a way that more expressly relates back to the reason the power is granted to occupational pension scheme trustees in the first place: namely, to deploy the scheme assets so as to best provide, in the circumstances of the scheme, the various benefit entitlements within that scheme (with desired risk-adjusted returns being decided accordingly).[48] A more purposive formulation such as this would seem to avoid the problem of steering readers towards comparative approaches, capturing instead the more fundamental ideas of the goals, standards of care, execution and context that are necessary in order to arrive at an investment decision which promotes the overall purpose of the pension scheme trust.

Whatever legal formulation of the investment power's purpose is preferred, it is suggested that it ultimately boils down to an even simpler central 'exam question' that trustees could ask themselves (and their advisers) whenever they are considering a proposed new investment or investment strategy:

> How is this helping us best achieve our objective of providing the benefits the scheme has been set up to provide?

The trustees' practical answer to that question, and therefore the scope for taking different issues, including sustainability considerations, into account when investing will then lie in the

45 See Bennett, P, (above n 13).

46 As was discussed at a joint seminar of the Association of Pension Lawyers and Society of Pension Professionals on 30 June 2022 regarding ESG and fiduciary duty, viewed by the author (membership required for access).

47 *British Airways*, (above n 35) at [61] per Patten LJ (dissenting).

48 The views of the sponsoring employer could also be relevant here (see n 22 above). In a defined benefit scheme, the concept of the 'circumstances' of the scheme mentioned in this formulation may include among other things the strength, longevity and visibility of the sponsoring employer's covenant.

outcome of the decision-making process that the law expects trustees to follow and the duty of care trustees owe when doing so. Consequently, it is to these aspects that we will now turn.

Decision-making process

What follows can only be the briefest possible summary of the huge amount of law in this area. To begin with, as a matter of general trust law, a trustee's power of investment is categorised as an administrative power.[49] This imports a series of well-known duties around how the investment power should be exercised.[50] These include duties to avoid formal or procedural defects and within the scope of the power, but there are four other key points to focus on here:

(a) *Ongoing duty to consider exercising the power*: In circumstances where trustees have been given an administrative power, as opposed to being under an obligation to act in a particular way, trustees must at a minimum consider from time to time whether to exercise the power which they have been given.[51]
(b) *Duty to give due or 'properly informed' consideration to any exercise of the power*: Where trustees decide to exercise a power which they have been given, they must act in good faith and take reasonable steps to gather information which is relevant to the exercise of that power.[52]
(c) *Duty to consider relevant factors (and no irrelevant factors) when taking the decision*: This is one of the key duties for the purposes of this article and it is discussed in further detail below.[53]
(d) *Duty to reach a decision that is not irrational or perverse*: Even where the correct factors have been taken into account and the decision-making process is otherwise proper, a decision can still be overturned if the trustees reach a conclusion which no reasonable decision-maker could have reached.[54]

It is well established that where trustees have followed a proper decision-making process, complying with these duties and not reaching an outcome that is irrational or perverse, a court would not overturn the decision if someone else in the same position might have reached a different conclusion.[55]

The duty to consider relevant factors is particularly significant in two respects.

First, it defines the legal filter through which *all* considerations, including sustainability considerations, need to pass before they can form part of a trustee investment decision. It is clear from the case law that this filter is not whether an issue is non-financial or financially material (or otherwise), but whether or not the consideration is relevant in the exercise of the investment power.

49 Tucker, L et al, *Lewin on Trusts* (20th ed, Sweet & Maxwell, 2020), Vol II, pp 8–9.
50 See, generally, the discussion in *Lewin on Trusts* (above n 49), Ch. 29.
51 *Sieff v Fox* [2005] EWHC 1312 (Ch).
52 *Kerr v British Leyland* [2005] 17 PBLR. Most occupational pension scheme trustees are also required by statute to take proper advice on investment matters – see s 36 of the Pensions Act 1995.
53 *Edge v Pensions Ombudsman* (above n 41), *Braganza v BP Shipping Ltd* [2015] UKSC 17. As part of this, trustees must set aside their personal views and beliefs.
54 *Ibid*, see also *Harris v Lord Shuttleworth* [1994] ICR 1991, Braganza, *Op. cit.*, and Pollard, D. *Pensions, contracts and trusts: legal issues on decision making*, *Op. Cit*, Chs. 51–55.
55 *Edge v Pensions Ombudsman*, (above n 41), [50].

This is a critical point: the case law recognises a broad but binary distinction between relevant and irrelevant factors in a decision, rather than a need to sub-categorise considerations in other ways.

Secondly, identifying which considerations are relevant, which are irrelevant, and how much weight to give any particular consideration in the decision, are in the first instance matters for the trustees to determine in light of the purpose of the investment power and the specific facts and context. Trustees are not required to identify and consider every conceivable relevant factor, but the duty of proper consideration implies at the very least a requirement actively to think about what obviously ought to be considered and what other issues are or are not permitted to be taken into account.[56] It is also clear that in the investment context, these decisions involve matters of trustee judgement as much as hard data analysis.[57]

Refocussing on relevance (and irrelevance)

Within the case law, the scope for taking any particular sustainability consideration into account therefore depends on its relevance to the investment decision that is being taken, which is a matter of trustee judgment after giving the issues proper consideration and appropriate weight within the decision, in the circumstances of the scheme. There does not seem to be any legal requirement for trustees to re-cut or reclassify the factors in their decision in a different way to this.

On a practical level it is also suggested that it is becoming difficult to sustain a view that sustainability considerations will always be entirely irrelevant factors for the purposes of the legal duties, or even that there is insufficient evidence to support their potential relevance to investment decisions, such that they should automatically be excluded from every trustee investment decision. Over the period since LC2014 then there has been further considerable thought, analysis and policy guidance linking sustainability considerations to wider investment decisions.[58] Given the above, it is suggested that:

(a) There is nothing that means sustainability considerations are so inherently irrational or irrelevant to trustee investment decision-making they should invariably be disregarded. Rather, it is suggested that, where supported by investment analysis, sustainability considerations can be and are relevant to investment risk and opportunity. This does not mean that sustainability issues will always sway a decision-maker irrespective of the circumstances. What it does mean is that the better legal starting point when facing an investment decision is to assess, with advice as needed, what role the given

56 For a further discussion of these issues, see Pollard, D, *Pensions, Contracts and Trusts: Legal Issues on Decision Making*, (above n 30), pp 235–333.

57 LC2014, pp 95, 126.

58 From the author's discussions with investment consultants, he is aware of a growing body of experience that suggests integrating ESG into investment strategy decisions can be value-additive, and that ESG factors can be financially material. This was also discussed by speakers at the joint Association of Pension Lawyers and Society of Pension Professionals webinar on ESG and fiduciary duty on 30 June 2022, viewed by the author (access requires membership). Another example is the government's statutory guidance on climate change governance under ss 41A(7) and 41B(3) of the Pensions Act 1995, which expressly sets out the policy view that climate change risks are financial risks – see Department for Work and Pensions, 'Governance and reporting of climate change risk: guidance for trustees of occupational pension schemes', June 2021, pp 12–13: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1006024/statutory-guidance-final-revised.pdf, accessed 21September 2022.

sustainability consideration can and should properly play in the decision, having regard to the purpose of the investment power and the wider context of the scheme in question (see above).

(b) The general decision-making duties give trustees an extremely wide discretion to construct their decisions, and the considerations that feed into them, as they see fit – as long as the broad basic requirements, including as to proper consideration, rationality, and relevance, are met.

(c) The 'financially'/'financially material'/'non-financial' concepts (and the sub-categorisations they involve) are not hard principles that were articulated within the case law – they are an analytical gloss upon it.

(d) Consequently, the fundamental legal requirement is not financial, financial materiality or the two-limb non-financial factors test, but *relevance*.

By linking contemporary investment analysis with a better understanding of this fundamental legal requirement for relevance, it is the author's view that practitioners will create the greatest potential for the two key issues mentioned at the start of this article (investment reality and legal principle) to come into alignment. It is therefore in this territory where, in the author's view, there lies the greatest potential to resolve the current uncertainties about the fiduciary duty when investing. Instead of focussing on debates about whether a factor is financially material or non-financial, by first articulating the criteria of relevance and the proper purpose of the investment power and then working collaboratively with investment advisers to establish whether the investment analysis supports a given sustainability consideration as relevant to that purpose, trustee legal advisers should be able to advise with greater clarity on whether the trustee's decision-making is following an appropriate legal process such that it should not be overturned.[59]

None of this is especially radical. Nor, in one sense, is it inconsistent with the Law Commission's analysis. LC2014 defined financially material factors as *'any factor* which is *relevant* to trustees' primary investment duty of balancing returns against risks' (emphasis added). As drafted, this definition is in itself extremely broad but more importantly, it seems clearly founded on the idea of relevance. Trustees and advisers could find considerable assistance in reflecting on the breadth of this concept. To put it another way, a financially material factor will by definition be a relevant factor. And if a consideration is relevant, it should be taken into account. If it is irrelevant, it should be disregarded irrespective of whether it might be categorised as financial or non-financial in nature.

However, lest this approach should be criticised as simply moving the goalposts from a 'non-financial' and 'financially material' dichotomy to a division between 'relevant' and 'irrelevant', it is important to recall that the Law Commission model involves four sub-categories: financial, financially material, non-financial, and impermissible (ie irrelevant): see above. It places four options in front of trustees when categorising an issue for investment decision-making, whereas the revised approach only involves a choice between two, addressing the categorisation problem within the current model and opening a clearer path towards a final decision.

59 The duty of care, discussed below, is also important to this.

Conclusions on the relevant factors test

By rediscovering the 'relevant factor' threshold, and its connection to the proper purpose of the investment power, practitioners may be able to adopt a more focussed and purposive approach to the fiduciary duty which asks trustees and their advisers to address:

- how the investment power can best be used to deliver benefits over the time-horizons of the scheme; and
- how their sustainability considerations fit within that picture.

Of course, the practical reality of these decisions would not be easy. The investment issues are nuanced and neither the real world of investment nor the job of a trustee are straightforward. But it should be clear that a revised perspective based upon relevance would help resolve the uncertainties around the financial, financially material and non-financial categories, allowing trustees and advisers to focus instead on the more pressing questions of why and how any given issue, including a sustainability consideration, is being, or should be, properly considered.

Duty of care

Another step that may move us forward would be to rediscover the trustee duty of care when investing. In fairness, this does often feature in the analysis and commentary, but it seems to have received comparatively less attention than the 'financially material'/'non-financial' debate.

The Law Commission felt that the duty of care sits alongside the trustees' other more specific duties when exercising a power (such as those outlined above).[60] The best-known case law formulation is that the duty is 'to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide.'[61] This does not mean the elimination of risk when investing,[62] nor is it to be assessed with the benefit of hindsight (or with the expectation of prophetic vision).[63] This should be reassuring to many trustee boards when grappling with the complexity of sustainability issues.

The state of the art

Of more immediate interest here, however, is the judicial recognition that the trustee's investment duty of care evolves. In *Nestle v National Westminster Bank*, Hoffman J (as he then was) held that the *Re Whiteley* formulation is:

> … an extremely flexible standard capable of adaptation to current economic conditions and contemporary understanding of markets and investments. For example, investments which were imprudent in the days of the gold standard may be sound and sensible in times of high inflation. Modern trustees acting within their investment powers are

60 LC2014, p 53.

61 *Re Whiteley* (1886) 33 Ch D 347 at 355. This was applied in *Cowan v Scargill* (above n 21), at [50], noting that the duty 'is not discharged merely by showing that the trustee has acted in good faith and with sincerity. Honest and sincerity are not the same as prudence and reasonableness.' See also Pollard, D, 'The "prudence" test for trustees in pension scheme investment: just a shorthand for "take care"', (2021) 34 TLI 215.

62 *Re Godfrey* (1883) 23 Ch D 483 at 493.

63 *Duchess of Argyll v Beuselinck* [1972] 2 Lloyd's Rep 172; *Nestle v National Westminster Bank* (1996)10 TLI 113 at [21].

> entitled to be judged by the standards of current portfolio theory, which emphasises the risk level of the entire portfolio rather than the risk attaching to each investment taken in isolation.[64]

Sometimes cited as specific support for portfolio theory, this authority is actually much wider than that: it establishes that in discharging the duty of care, trustees can (and arguably should) have regard to contemporary investment theory, of which portfolio theory was merely a prescient example at the time the case was decided.

This is significant in relation to sustainability considerations, where industry thinking is continuing to develop. A discussion of the investment theory is beyond the scope of this article, but the concept of an evolving duty of care means that at a minimum it can be argued that trustees should discuss with their advisers how far contemporary investment analysis is revealing:

- how sustainability issues may affect particular scheme investments or asset classes over the short-, medium- and long-term (noting, as above, that these risks can sometimes crystallise in sudden or unexpected ways);
- how sustainability considerations may correlate with systemic risks in the economies and finance which may now be starting to crystallise, whereas previously these issues may have been characterised as too remote or nebulous to be properly relevant to trustee investment decisions; and
- how the above may affect the investment strategy.[65]

In that context, the question of how investment risks and opportunities arising from sustainability can be addressed within the portfolio becomes a legally relevant issue. Put bluntly, is the portfolio (and therefore the purpose of the scheme) ultimately best served by deploying assets in ways that contribute to and thus reinforce exposure to economic and social systems which may not be sustainable over the time-horizon of the scheme or which increase the risk of short-term downside, while the scheme may now have other or better opportunities to avoid these issues by pursuing an alternative investment course?

As our understanding of the interplay between sustainability considerations, systemic risk and investment performance evolves and becomes more nuanced and sophisticated, the trustee standard of care likewise evolves. We urgently need a debate around 'the state of the art' here. Eight years after the first Law Commission report, the position in relation to the relevance of sustainability risks and opportunities, including systemic risks, to the duty of care when investing is surely ripe for reappraisal.

Stewardship and engagement

A second feature to recover from the duty of care is the idea that it encompasses a degree of active stewardship of investments. The facts of a key case in this area, *Bartlett v Barclays Bank Trust Co Ltd*, are relatively unlikely to arise in the context of many occupational pension scheme

64 *Nestle v National Westminster Bank* (above n 63), at [21].

65 See *Cowan v Scargill* (above n 21), at [61] and LC2014, in particular the discussion of improving of the UK economy as a non-financial factor at pp 117–118. Practical areas that would, in the author's view, benefit from further discussion and education as between lawyers, investment consultants and economists are: (i) the emerging commercial and financial evidence to support ESG considerations as value-additive within investment strategies, and (ii) the extent to which systemic economic risks are starting to feature, particularly for open and/or relatively immature pension schemes.

investment strategies today. In the case, the defendant owned 99.8 per cent of a company which made a bad business decision, resulting in a loss to the trust, in circumstances where the trustees had had little practical engagement with the company directors other than through information provided at AGMs. The court found that because of the controlling position it had taken the bank was liable to make good the loss to the trust. The circumstances were extreme, but the key point is that the court applied the 'prudent man of business' standard to establish the level of stewardship of the company that ought to have been applied:

> Appropriate action will no doubt consist in the first instance of inquiry of and consultation with the directors, and in the last but most unlikely resort, the convening of a general meeting to replace one or more directors. What the prudent man of business will not do is to content himself with the receipt of such information on the affairs of the company as a shareholder ordinarily receives at annual general meetings.[66]

Stewardship and engagement are also growing areas of focus for pensions policymakers. Regulations already require most occupational pension scheme trustees to set out in a statement of investment principles their policies as to the exercise of rights (including voting rights) and engagement activities in relation to their investments; and this requirement is to be broadened and deepened through statutory and non-statutory guidance.[67] Thinking on this area has developed further since LC2014 and LC2017, with suggestions that active stewardship and engagement can positively contribute to investment value.[68] By providing scope for broader ongoing strategic investment activity as a potential alternative to blunt investment and disinvestment decisions, stewardship and engagement also provide a potential practical answer to the challenge that individual schemes cannot be expected to act on sustainability because they are not large enough to influence markets or investee behaviour on their own.

It therefore appears from the case law that stewardship is better seen as a legitimate investment risk mitigation tool for trustees as part of the duty of care. The types and level of stewardship activity that are needed to discharge that duty are flexible, depending in part upon the level of exposure to and control of the investment. In the context of typical occupational pension scheme investment strategies today, which are often highly diversified and which involve comparatively little direction from trustees below the strategic level (partly for regulatory reasons), one might therefore expect trustees to be at relatively low risk of breaching this duty. Nevertheless, it is suggested that the duty of proper consideration means trustees are not at liberty to ignore questions of stewardship entirely. This is particularly the case in relation to system-wide sustainability risks such as climate change which are much harder to address by diversification within the portfolio.

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66 [1980] Ch 515.

67 Regulation 2(3)(c), the Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378). This provision derives from SRD II (Directive EU 2017/828), reflecting rising expectations among European policymakers as to standards of stewardship by large institutional investors. Separately, occupational pension scheme trustees are also required to report publicly on, among other things, their key voting behaviour in an annual 'implementation statement' as part of the scheme accounts: see reg 12(5) of the Occupational Pension Schemes (Disclosure of Information) Regulations 2013, as amended (SI 2013/2734). As to the next developments on and from 1 October 2022, see the Department for Work and Pensions Consultation Response 'Climate and investment reporting: setting expectations and empowering savers' (June 2022), www.gov.uk/government/consultations/climate-and-investment-reporting-setting-expectations-and-empowering-savers/outcome/government-response-climate-and-investment-reporting-setting-expectations-and-empowering-savers, accessed 21 September 2022.

68 See for example, Wallis, R (Ed), 'How ESG engagement creates value for investors and companies, (Principles for Responsible Investment, 2018), www.unpri.org/research/how-esg-engagement-creates-value-for-investors-and-companies/3054.article, accessed 21 September 2022.

Conclusions on the duty of care

The duty of care complements a refreshed decision-making duty based on relevant factors, by prompting trustees to take account of both evolving investment market thinking, and to think about how to manage investment risk in the portfolio by prudent and proportionate but active stewardship.

Investment policies and disclosures

Moving away from the case law, our final stop brings us to the extensive sustainability-related legislation that now applies in relation to occupational pension scheme investment. Among others that could have been chosen,[69] the example here is the requirement to have a statement of investment principles setting out, among other things, the trustees' policies in relation to:

(a) financially material considerations over the appropriate time horizon of the investments including how those considerations are taken into account in the selection, retention and realisation of investments; and
(b) the extent (if at all) to which non-financial matters are taken into account in the selection, retention and realisation of investments.[70]

Further regulations require the statement of investment principles to be displayed on a publicly accessible website.[71]

These requirements are clearly derived from LC2014: financially material considerations are widely and non-exhaustively defined as including (but not limited to) environmental, social and governance considerations (including but not limited to climate change), which the trustees of the trust scheme consider financially material. Non-financial matters means the views of the members and beneficiaries including (but not limited to) their ethical views and their views in relation to social and environmental impact and present and future quality of life of the members and beneficiaries of the trust scheme.[72]

The structuring of these obligations is interesting. First, the regulations do not impose a direct duty to take account of financially material considerations or non-financial matters. Rather, they are a requirement to set out policies on these matters. Of course, in order to be able to state these, trustees need to have actively turned their minds to what those policies should be. The regulations are, in effect, a 'call to action'. Secondly, because the statement of investment principles is publicly available, there is the prospect of greater transparency (and thus accountability) for the scope and quality of those policies as the scheme compares itself to its peers, or as members or other stakeholders engage with the trustee about the stated policies. In another forum, the author has argued that as a result of this, industry best practice is likely

69 Another example is the Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 (SI 2021/839).

70 Regulation 2(3)(b)(vi) and (vii) of the Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378 as amended).

71 Regulation 29A(1A) of the Occupational Pension Schemes (Disclosure of Information) Regulations 2013 (SI 2013/2734 as amended).

72 Regulation 2(4), the Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378) as amended. These terms appear to be intended to broadly reflect the 'financially material'/'non-financial' formulation developed by the Law Commission, though there are differences in precise terminology. The statutory language is not necessarily inconsistent with a reframed general fiduciary duty of the type suggested above because the statutory definition of 'financially material considerations' is extremely wide and is framed by reference to each trustee's subjective judgement.

to develop over the coming years towards an emphasis on more focussed and actionable policy statements than may have been the case in the past, drawing a distinction between these and the Pensions Regulator's concept of higher-level 'investment beliefs'.[73]

By requiring trustees to take this approach, the statutory regime in effect acts to reinforce the potential relevance of sustainability considerations within the fiduciary duty, and at the very least to encourage trustees to consider the issues.

Conclusions

There remains a degree of caution about the extent to which sustainability considerations are compatible with occupational pension trustee fiduciary duties when investing. There are some continuing uncertainties about the model first put forward by the Law Commission in 2014. Some of these are substantive uncertainties about the state of the law as it applies to occupational pension schemes. In other areas the law is clearer but its practical application has arguably become clouded.

This article has sought to outline a slightly different way of looking at the fiduciary duty, in line with the established case law but with a view to moving past the categorisation problem of financial/financially material/non-financial factors. The article has suggested that it might be possible to achieve this by rediscovering the underlying key legal principles. Specifically, this involves:

- refocussing legal analysis on helping trustees properly to identify and consider the *relevance* of different investment issues and strategies, including sustainability considerations, to their ultimate purpose of providing benefits in the specific circumstances of each scheme. Whilst this is intensely fact specific, it is suggested that sustainability considerations can in theory (and increasingly in practice) be highly relevant in this context;
- as part of the duty of care, prompting trustees and advisers actively to enquire into 'the state of the art' in investment thinking and how this affects the scheme, including the developing understanding of specific sustainability risks and opportunities and risks arising from unsustainable economic or social systems, and then looking at how to incorporate this evolving thinking into investment strategies; and
- the role of active stewardship as a matter of both the investment duty of care and the statutory requirement for (actionable) investment policies.

There is a lot more work to do on this topic, but perhaps there are the beginnings of a conversation here. The legal principles interact strongly with investment analysis and economic and practical circumstances, both of each scheme and more widely. Sustainability considerations can most easily be taken into account where the investment reality aligns with an understanding of the law. This article has sought to outline a legal perspective which may help create that alignment – but the development of workable practical approaches in this complex area will, above all, best be achieved through close collaboration and genuine dialogue between occupational pension trustees and their legal and investment advisers.

73 See 'ESG: from policies to practice', specialist session webinar at the PLSA ESG Conference 2021, www.traverssmith.com/knowledge/knowledge-container/esg-from-policies-to-practice-pensions-and-lifetime-savings-association-plsa-esg-conference-2021/, accessed 21 September 2022.