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To whom it may concern,

FairPensions Response to Consultation: '*Charities and Investment Matters*'

About FairPensions

FairPensions is a registered charity established to promote Responsible Investment by UK institutional investors, including pension schemes and fund managers. Responsible Investment is defined as the active management of environmental, social and governance (ESG) risks with the potential to affect long-term financial returns. We advocate a strategy of active engagement with investee companies (ie. the use of shareholder rights, including voting rights) to improve performance.

We are a member organisation with a diverse membership including major UK charities (Oxfam, WWF, Amnesty International, ActionAid, CAFOD, and the Eccumenical Council for Corporate Responsibility). In addition, several trade unions and organisations which represent pension fund beneficiaries are members of FairPensions including UNISON, UNITE and the National Federation of Occupational Pensioners. Finally, we have a supporter base of almost ten thousand individuals in the UK.

FairPensions is supported financially by some of the UK's best known charitable foundations including Esmee Fairbairn Foundation, Nuffield Foundation, Joseph Rowntree Charitable Trust, Ashden Trust (one of the Sainsbury Family Trusts), and the Friends Provident Foundation.

Introduction

We welcome the draft guidance as an improvement on previous guidance and a helpful attempt to address important issues on which there is considerable confusion among trustees. In general we applaud the guidance's clarity and efforts to make complex investment concepts understandable for trustees. However, we believe there are several respects in which the guidance could be further improved to avoid confusion or unnecessarily restrictive interpretations. Below we make a number of general and specific comments. Many of these are informed by a recent series of expert seminars and in-house research undertaken by us in preparation for a major new report on the future of fiduciary obligation, which will be published on 30th March 2011. We will ensure that the Commission receives a copy of this report. In the meantime we would be pleased to meet with representatives of the Commission to discuss the report's findings and their relevance to the draft guidance.

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The campaign for **responsible** investment

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Ethical Investment

The draft guidance on ethical investment is generally helpful and accords with our understanding of the law as set out in our forthcoming report on fiduciary obligation.

We would suggest that it might be helpful to provide some further practical guidance, perhaps by way of a brief case study based on the facts of the Bishop of Oxford case, to help trustees gain a feel for how the abstract concepts under discussion might translate into real-world investment policies. In our experience, trustees often interpret general guidance as restricting their room for manoeuvre in practice, for instance believing that they would not be permitted to exclude an entire sector. Many trustees are unaware that the judge in the Bishop of Oxford case, whilst rejecting a proposed policy that would have excluded 37% of UK-listed companies by value, explicitly upheld a policy which excluded 13%, including armaments, gambling, alcohol, tobacco and newspapers.

In particular, the question of whether a particular screening policy would cause 'significant financial detriment' is vexed: one still comes across arguments that no screening policy could be justified on this basis, since it would inevitably compromise trustees' ability to diversify.[1] It might be helpful in this context for the Commission to provide examples of the position the courts have taken on this issue in the past – including, for example, the statement in the Bishop of Oxford case that *"It is not easy to think of an instance where in practice the exclusion [for ethical reasons] of one or more companies or sectors from the whole range of investments open to trustees would be likely to leave them without an adequately wide range of investments from which to choose a properly diversified portfolio."*[2] This could be included in the document on 'legal underpinnings' if the Commission is concerned to avoid over-complicating the guidance itself.

In the guidance on 'significant financial detriment', the emphasis on "moral grounds that are in the charity's interests" may also be confusing without further elaboration. This might appear to suggest that, in order to justify a decision on this basis, trustees would have to show a demonstrable non-financial benefit to the furtherance of the charity's aims, rather than simply a moral conflict perceived by some of the charity's stakeholders, as seems to be the rule in the Bishop of Oxford Case (*"Trustees may, if they wish, accommodate the views of those who consider that on moral grounds a particular investment would be in conflict with the objects of the charity")*. Indeed, the draft guidance may be less clear and more restrictive in this respect than the previous formulation.

Responsible Investment

The omission of 'responsible investment' from the range of investment approaches discussed is an unfortunate oversight. Responsible investment is defined as "the integration of ESG [environmental, social and governance] criteria into mainstream

1 See for example Rosy Thornton, *'Ethical Investments: A Case of Disjointed Thinking,'* 2008, Cambridge Law Journal 67(2), July 2008
2 At 304

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investment decision-making and ownership practices".[3] FairPensions works primarily with occupational pension schemes, and we have noted a contrast between the pensions and charitable spheres in this area. In the pensions world, 'ethical investment' has been marginalised, while responsible investment has gained increasing currency particularly since the UN-supported Principles for Responsible Investment were launched in 2005. In the world of charitable investments, the reverse appears to be true, with ethical investment continuing to have significant profile but, as yet, minimal penetration of responsible investment thinking into the sector. FairPensions believes that both these approaches are legitimate and valuable, and suggests that the preparation of this guidance offers an important opportunity to address the relative lack of understanding of responsible investment approaches in the charitable sphere.

In particular, a range of legal and investment experts in this country and overseas increasingly take the view that the active consideration of financially material ESG issues is part of any investor's fiduciary duty to invest prudently. A legal opinion commissioned by the UN Environment Programme in 2005 concluded that "*it may be a breach of fiduciary duties to fail to take account of ESG considerations that are relevant and to give them appropriate weight.*"[4] If ESG risks are indeed material to investment success, then it follows that for charities with invested assets, their ability to most effectively pursue their objects requires appropriate consideration of such investment risks. It is important to distinguish the legal position on this issue from the legal position on ethical investment. Charity trustees would benefit from the Commission's guidance on this matter.

To be clear, we do not suggest that the term 'ethical investment' should be replaced by 'responsible investment', since we regard these as two distinct approaches. Ethical investment is generally understood to refer to ethically-*motivated* investment policies, and is often associated with screening. Responsible investment is generally understood to refer to financially-motivated integration of ESG issues, and is often associated with engagement-based approaches. The guidance rightly notes that investment policies – including screening – based on purely ethical criteria can be permissible for charities. Replacing this with references to responsible investment could add to the existing confusion over whether and when ethically-motivated investment policies are permissible. Indeed the elision of ethical investment with 'business-case' responsible investment may cause some confusion even in the existing draft documentation. For instance, the accompanying document on 'Legal Underpinnings' (para 4.6) refers to the *"increasingly held view that companies which act in a socially responsible way are more likely to flourish and to deliver the best long-term balance between risk and return."*

It would be more helpful if this statement – both in the document in question and in the guidance itself – formed part of a full explanation of responsible investment rather than being conflated with strictly ethical approaches. We would suggest that this could be

3 Available at www.unpri.org
4 UNEP-FI, 2005, '*A legal framework for the integration of environmental, social and governance issues into institutional investment*', p100

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included either as an additional category of investment, or within the main body of the guidance on 'financial investment' (ie sections D, E or H).

Risk and return

The consistent use of the term 'best financial return' without qualification is concerning, particularly as no mention is made of levels of risk. Our understanding of the relevant case law is that the obligation to seek a good return clearly refers to *risk-adjusted* returns, as for instance in Cowan v Scargill: *"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."*

FairPensions' forthcoming report considers the history and evolution of fiduciary obligation, and notes the shift in emphasis which has taken place over the centuries from capital preservation to maximisation of returns. This trend may well be a sensible and necessary adjustment to changing investment norms, but it is vital that it does not become stripped of any appreciation of the importance of risk management. Sections D6 and E2 are helpful in this regard but it would be even more helpful if this could be integrated into the references to financial return elsewhere in the document, for instance by amending them to refer to 'the best risk-adjusted financial return', or 'the best financial return for a given level of risk'.

This also relates to our suggestions regarding responsible investment above. It would be concerning if trustees interpreted the requirement to seek the 'best financial return' as preventing them from considering material ESG risks if this might result in short-term underperformance, even if such a strategy would be financially prudent in the long-term. It might also be helpful to add ESG to the explanation of types of risk on pages 21-22 (the 'G' in ESG could perhaps be referred to as 'corporate governance' in order to clearly distinguish it from the 'governance risks' described on p22).

Mixed purpose and programme related investment

We are concerned that the guidance may suggest an overly rigid framework of separate investment approaches. Although section B3 does state that *"trustees can choose to concentrate on just one approach or a combination"*, the general tone of the guidance frames trustees' decisions in terms of choosing an approach based on their priorities – for instance, section B4 headed 'How to decide on the right approach?' and the statement on p5 that *"there are a number of approaches [trustees] can adopt depending on whether they decide it is in their charities' best interests to... [etc.]"*

This somewhat rigid approach is reflected in the guidance on mixed purpose investment, which is relatively short and could be read as discouraging trustees from pursuing this approach. Likewise, it would be helpful if the guidance provided some comment on how different types of investment might interact as part of a prudent whole portfolio strategy.

More generally, we share concerns expressed that the draft guidance may not fully realise its intention of freeing trustees to pursue more innovative and flexible approaches to

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furthering their charitable aims, and may still discourage charities from engaging in such investment. The guidance's confirmation, in section G3, that *"trustees are unlikely to be criticised for adopting a particular policy if they have considered the correct issues, taken appropriate advice and reached a rational result"* is welcome. This crucial point could be made clearer elsewhere, for instance in the general guidance and in the sections on programme-related investment and mixed purpose investment. At times the requirements for measuring impacts and demonstrating that a particular investment served the charity's best interests may seem unnecessarily bureaucratic. Trustees might benefit from more general guidance which steps back from these minutiae and reiterates that the key legal consideration is whether they have exercised their judgement in a reasonable, prudent and properly-motivated way.

Finally, there appears to be an imbalance between the emphasis placed on 'private benefit' in the guidance on programme-related investment, and the absence of such considerations from the guidance on financial investment. It may appear as if a different threshold is being applied to the acceptability of private benefit in the context of social investment as compared to, for instance, the private benefit derived by fund managers from fees. Indeed, as discussed in chapter 2 of our forthcoming report on fiduciary duty, we consider that monitoring and controlling investment agents' fees, and ensuring that they are reasonable and represent good value for the trust, is a crucial part of modern fiduciary obligations. The same test should be applied in the context of social investment. A similar point could be made with regards to the emphasis placed on 'exit certainty' in relation to programme-related investment. The Commission should seek to ensure consistency between its treatment of financial and social investment in these respects; otherwise the guidance risks perpetuating the impression of many trustees that, in the words of one participant at our recent seminar, *"the kind of hoops you need to jump through [on social and responsible investment] are completely different from any other investment decision."*

We remain at your disposal should you wish to discuss any of these issues further.

Yours sincerely,

Catherine Howarth

Catherine Howarth
Chief Executive, FairPensions

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