Background
The Law Commission has investigated the duties of investment intermediaries to act in the best interest of the savers whose money they manage, and published its final report in July 2014. Its clarification of the legal framework governing pension fund investments will have significant implications for the way in which trustees make decisions, including how they have regard to ESG risks, non-financial factors and members’ concerns.

The Commission’s review arose from concerns that institutional investors are failing to invest on the basis of the fundamental value of companies, and have done little to control bad company decisions. Along with other stakeholders in industry, academia, and civil society, ShareAction submitted evidence to the review expressing concern that many pension funds and fund managers interpret their legal duty as a ‘duty to maximise returns’, which contributes to a neglect of factors which are not immediately monetisable, such as ESG issues.¹

The Commission has made important statements about the legal position which we welcome. This briefing provides a brief outline of the Commission’s findings and suggests some steps pension funds may wish to take in light of these conclusions.

Summary
• Pension fund trustees do not have to ‘maximise returns’ in the short term at the expense of risks over the longer term
• Trustees should take into account factors which are financially material to the performance of an investment. Where trustees think environmental, social or governance issues are financially material they should take them into account
• The law permits trustees to make investment decisions that are based on non-financial factors, provided that there is no risk of significant financial detriment to the fund, and that trustees have good reason to think that members would share the concern. This includes members’ ethical concerns and quality of life
• Governance committees embedded in workplace DC pension providers should have a duty to act in members’ interests
• Stewardship of investee companies is appropriate for funds of all sizes
**Key Findings**

**Trustees are not obliged solely to maximise returns**

The Law Commission accepts ShareAction’s view that trustees are not required to ‘maximise returns’. Since trustees’ main job is to secure the best realistic return over the long term, there is a need to control for risks which may affect the sustainability of a company. The Commission emphasises that such risks must be judged at the time of the decision and not in hindsight.

**Trustees should take account of financially material factors, including ESG issues**

ESG issues can have an impact on financial performance, and as such, trustees are ‘clearly’ permitted to take them into account. The Commission states that “there can be no objection to using ESG factors as a way of increasing long-term performance”. Indeed, given the evidence of financial impact, “trustees should consider, in general terms, whether their policy will be to take account of ESG factors”.

The Commission also confirms that in cases where the macroeconomic impact of an investment impacts on the portfolio as a whole, it might be considered as a financial factor of which trustees are free to take account.

However, the Commission stops short of saying that ESG integration is required of fiduciaries, since an ESG issue may not necessarily be financially material. Trustees must make an assessment of which factors are financially material and the weight they should be given.

The Commission concludes that trustees “should take account of financially material risks”. To reflect this finding, ShareAction recommends that investors:

- Undertake an evaluation of their exposure to ESG risks, quantifying those risks where possible
- Develop a policy that sets out fund-specific objectives and priorities for managing ESG risks

**Trustees may take account of non-financial factors**

The Law Commission states that although generating financial return should be trustees’ predominant concern, the law does not require it to be their sole objective. Non-financial factors may be taken into account subject to a two-step test; (1) trustees have good reason to think that members would share the concern; and (2) the decision does not risk significant financial detriment to the fund.

The Commission only provides limited detail about what this would mean in practice, but stresses that the courts would focus on the process followed by trustees rather than the ultimate decision reached. Trustees must act on the views of their beneficiaries rather than their own views.

Non-financial concerns might include decisions aimed at improving beneficiaries’ quality of life, such as through seeking investments in infrastructure schemes. Quality of life considerations should remain subordinate to financial objectives, and the two tests still apply; trustees should have good reason to think that beneficiaries would welcome the lifestyle benefit, and that there would be no risk of significant financial detriment to the scheme.
The same is true of members’ ethical concerns, where funds make a decision to disinvest from particular industries such as tobacco or arms, in order to show moral disapproval.

The Commission acknowledges some flexibility within the application of the two tests. For example, if trustees are faced with compelling evidence that members feel very strongly about the issue, then they may be justified in accepting a risk of some possible detriment, so long as the detriment is not significant. And if trustees receive advice that the decision is financially neutral, with some members agreeing and some indifferent, then trustees may still go ahead.

In some cases, trustees can make assumptions about beneficiaries’ views without carrying out surveys. For example, the UK’s ratification of an international agreement prohibiting cluster bombs would give trustees good reason to think that many people would consider them to be wrong. The Commission regards this as an example where the evidential requirement to show that beneficiaries share the concern may be ‘relatively light’. In such circumstances, letters from members sharing a particular view would give trustees good reason to think that they were acting on members’ concerns rather than their own.

In other cases, a poll of members may be necessary. There does not need to be 100% agreement. If a majority are opposed to an investment while the rest remain neutral, that would be enough.

However, where there is strong disagreement between a majority and a minority of beneficiaries, difficult questions arise in relation to the trustees’ duty to treat all beneficiaries impartially. The courts may well expect trustees to focus on financial factors rather than becoming embroiled in disagreements between the beneficiaries.

Trustees are likely to find that members, armed with the Commission’s assurance over pension funds’ freedom to reflect member views, will expect their concerns to be listened to. In order to meet these expectations, trustees should take steps to involve members in their decision making processes. In ShareAction’s view, it is best practice for funds to:

- Include member representation in their governance structures
- Provide members with basic annual reporting about their investments including:
  1. where the money is going
  2. the investment strategy and long-term future outlook
  3. how shareholder rights have been exercised on the fund’s behalf
- Respond promptly and substantively to member enquiries about stewardship and responsible investment issues

Stewardship of investee companies is appropriate for funds of all sizes

In its initial consultation paper, the Commission implied that stewardship is only cost-effective for the largest funds. This stemmed from a misconception that stewardship requires direct monitoring and engagement with companies on the part of pension funds. As ShareAction and others pointed out, stewardship in practice more often entails the appointment and monitoring of asset managers with strong stewardship capabilities. This is clearly feasible for smaller schemes.
The Commission accepts this position in its final report, and states its view that trustees should be encouraged to consider whether and how to engage with companies to promote their long-term success, either directly or through their investment managers, and recommends the introduction of a specific requirement for Statement of Investment Principles to include a policy, if any, on stewardship.

The Commission acknowledges that it is clearly in the interests of pension funds as a whole to do all they can to promote the long-term success of the companies in which they invest. We agree. NAPF suggests some simple actions which can be expected of pension funds as the owners and providers of capital:

- Include a section on ‘stewardship’ within their fund’s Statement of Investment Principles
- Include stewardship criteria in manager searches
- Incorporate monitoring of stewardship activities into manager reviews

Confusion exists over the application of the law in practice

The Commission accepts the concern expressed by ShareAction and others that the law is confusing and inaccessible. No single point of reference exists to tell trustees how they should apply their minds to the decision-making process. Consultees warned that this can lead to a failure to consider long-term sustainability and a neglect of beneficiaries’ concerns.

What Next?
ShareAction agrees with the Commission that despite the publication of this report, it is likely that legal advice will continue to be risk averse and unduly cautious. We welcome the Commission’s recommendations that the Pensions Regulator and FCA take steps to embed these findings in guidance, but feel that this will be an insufficient remedy to the problem of confusion over the practical application of the law.

We are calling on Government to clarify the law in statute, to make explicitly clear that pension fund trustees may take a long-term and responsible view of their fiduciary responsibilities. This will help to ensure that the law supports rather than impedes long-term, responsible investment of pension savings. This call was supported by several major investors, including Schroders and Aviva in a letter to Vince Cable in early July 2014.

End Notes

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About ShareAction
ShareAction (Fairshare Educational Foundation) is a registered charity that promotes responsible investment practices by pension providers and fund managers. ShareAction believes that responsible investment helps to safeguard investments as well as securing environmental and social benefits.

The opinions expressed in this publication are based on the documents specified in the end notes. We encourage readers to read those documents. Online links accessed 22 August 2014. ShareAction is not an investment advisor and makes no representation regarding the advisability of investing in any particular company or investment vehicle. Fairshare Educational Foundation is a company limited by guarantee registered in England and Wales number 05013662 (registered address 16 Crucifix Lane, London, SE1 3JW) and a registered charity number 1117244.