FairPensions™
The campaign for responsible investment

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Thursday 28 June 2012

To whom it may concern,

Red Tape Challenge: Civil Society – Social Investment

Please find enclosed a copy of FairPensions' recent report, *'The Enlightened Shareholder: Clarifying investors' fiduciary duties'*, along with a short briefing which discusses its implications for social investment.

The problem

In our experience, narrow interpretations of institutional investors' fiduciary duties are a major perceived barrier to greater uptake of socially beneficial investment opportunities. Most institutional investors believe that they are legally prohibited from considering the potential social value of their investments and must instead make decisions solely on the basis of projected risk-adjusted returns.

Of course, institutions such as pension funds exist to deliver a return on their beneficiaries' investment, and this must be their primary objective. For this reason, not all social investment opportunities will be appropriate for such investors. However, many pension savers may wish to see their money invested in ventures which deliver a positive impact in their community or wider society. Investors should be able to adopt an 'other things being equal' approach, whereby they seek to make investments that deliver social value for their beneficiaries provided this does not materially damage investment returns. Moreover, they should be able to adopt a common-sense approach to what 'equal' means in this context – in other words, the question should not be whether a given social investment is exactly mathematically equivalent to the alternative, but rather whether there is a *material* difference to investment outcomes for beneficiaries.

FairPensions has conducted extensive research into the (unfortunately limited) case law in this area and has concluded that none of the above principles contradict the existing common law. However, there is considerable confusion on this score, with opinions differing among lawyers, investors and academic experts. In this context, lawyers and their clients tend to take a highly cautious approach for fear of incurring legal liability for breach

The Charity Awards 2010 Highly Commended of fiduciary duties.

There is an urgent need to free trustees from the perception that their fiduciary duties require them to unthinkingly adhere to conventional investment wisdom, and restore the primacy of trustees' discretion to weigh up the best way to serve their beneficiaries' interests. This requires a return to first principles: the heart of fiduciary obligation is not a requirement to maximise returns, but to act prudently in the best interests of beneficiaries. The Charity Commission's revised CC14 guidance stressed that:

"If trustees have considered the relevant issues, taken advice where appropriate and reached a reasonable decision, they are unlikely to be criticised for their decisions or adopting a particular investment policy."[1]

The same principle needs to be reasserted in relation to pension fund trustees.

Case study

One large pension fund, which did not wish to be named, told us that they had received legal advice to the effect that their policy in relation to shareholder engagement and responsible investment might be unlawful. Briefly, the policy stated that the fund would seek to exercise voting rights in listed companies in which it held shares, and that it would take into account environmental, social and governance (ESG) issues with the potential to affect long-term value for the fund's beneficiaries. This position is firmly grounded in the financial interests of beneficiaries, and is widely accepted as best practice within the industry. The government has also endorsed such an approach by promoting the UK Stewardship Code, through its recent package of enhanced shareholder rights on executive pay, and in the Commons, where Pensions Minister Steve Webb has said:

> *"the coalition Government fully support the highest standards of corporate governance and ethical behaviour. We agree that a socially responsible investment strategy is a sound choice for pension schemes."*[2]

Despite this, the advice – from a large and reputable law firm – took an extremely narrow view of beneficiaries' best interests, and suggested that the costs involved in exercising voting rights might render the policy unlawful unless the firm could demonstrate that such stewardship brought monetisable benefits to the individual fund. The opinion cast doubt on whether such benefits could be demonstrated.

Although this example does not relate to social investment, it illustrates the problems faced by pension fund trustees who wish to take an enlightened view of their responsibilities, but are held back by unduly narrow interpretations of their legal room for manoeuvre. If anything, the barriers faced by social investment – a relatively new area with a less well-established industry consensus as to best practice – are likely to be far greater.

Impact on social investment

This narrow interpretation of pension funds' room for manoeuvre has a chilling effect on the development of the social investment market. Social investment is unlikely to break into the mainstream until this issue is resolved. As noted in the final report of the Social Investment Task Force in 2010, UK philanthropic foundations represent £65.6bn of

[1] CC14, Section B – Executive Summary. http://www.charitycommission.gov.uk/publications/cc14.aspx

[2] House of Commons Hansard, 20 Jan 2012, Col 1045

capital,[3] compared to the estimated £1,900bn held in UK pension funds.[4] Accessing this pool of capital will be crucial if the social investment market is to achieve scale. Indeed, relatively tiny proportions of pension fund investment could make a significant difference to the viability of this market whilst having minimal effect on the risk profile of funds' overall portfolios. Yet even the Task Force's suggested 0.5% of institutionally managed assets seems unlikely to materialise unless the perceived legal barriers described above are unblocked.

Possible solutions

A) Regulatory guidance

One potential solution is for The Pensions Regulator to issue guidance clarifying the scope of trustees' powers. This would be a helpful step forward but is highly unlikely to be sufficient – particularly in relation to social investment, a new area with no case law and no clarity over what the legal position might be if a case did come to court. Indeed, the limitations of such an approach are already becoming apparent in relation to the Charity Commission's revised CC14 guidance. As stakeholders have argued, the problem with such guidance is that it does not change the underlying legal position. It is therefore unlikely to reassure lawyers who feel that the law is uncertain, and who therefore give their clients cautious advice.

B) Amendments to secondary legislation

In relation to pension fund trustees, clarification could be achieved by amending the Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378). Such clarification would be permissive, with the aim of creating an enabling environment for the reasonable exercise of trustees' discretion. It would clarify that trustees may consider the impact of their investments on beneficiaries' non-financial interests – including the potential positive impacts of relevant social investments – as long as this does not threaten their overriding duty to protect beneficiaries' financial interests. FairPensions has produced draft legislation which illustrates how this could be done in practice (set out in Appendix 1 of the enclosed report). It is modelled on Section 172 of the Companies Act 2006, which aimed to address a similar problem with narrow interpretations of company directors' fiduciary duties. We believe that this could be implemented through new secondary legislation.

C) A Fiduciary Investors Act

One limitation of the approach outlined above is that it only covers pension fund trustees. As Pensions Minister Steve Webb pointed out in a Commons debate on the issue, it is desirable to have a level playing field whereby the same provisions apply to all those managing people's pension savings – including asset managers and insurance companies. However, this is a more complex area, since there are already major differences in the legal regime governing different types of pension provider. Indeed, the consensus position appears to be that insurance companies do not have fiduciary duties at all. Dealing with this in a coherent way may require primary legislation.

Whether or not the government wishes to deal with this wider issue, there are of course

[3] Social Investment Task Force, April 2010, 'Social Investment – Ten Years On', p16. http://www.socialinvestmenttaskforce.org/downloads/SITF_10_year_review.pdf
[4] TheCityUK, Pension Markets: March 2012

various types of trustees and fiduciary investors other than pension fund trustees, to whom similar issues apply. There may therefore be a case for a 'Fiduciary Investors Act' to address the problems facing pension fund trustees alongside the parallel issues raised by stakeholders in relation to, for example, charitable trustees.

We would be pleased to provide additional detail on any of the issues discussed above. Please do not hesitate to contact me should you require further information.

Yours sincerely,

Christine Berry

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