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The Department of Work and Pensions
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Response to consultation on changes to the Investment Regulations following the Law Commission's report "Fiduciary Duties of Investment Intermediaries"

1. ShareAction (formerly FairPensions) is a registered charity established to promote transparency and responsible investment practices by pension funds and other institutional investors. We are a member organisation and count amongst our members a growing number of NGOs and trade unions, as well as over 35,000 individual supporters.

2. ShareAction has been working on the issue of trustees' fiduciary duties since 2010. We fed into the Government-commissioned Kay Review of UK equity markets and the Law Commission's subsequent review of the law in this area. We gave evidence to the Business, Innovation & Skills Committee on this work and have worked closely with experts to develop our views on the necessary policy and legal changes.

Summary of key points and recommendations

3. It is critically important that the Occupational Pension Schemes (Investment) Regulations 2005 (the **"IR"**) are amended in a way which: (i) properly reflects what the Law Commission found and (ii) encourages good practice amongst trustees, which is still not universally followed. We recommend that the Government ensure this by requiring the following under the IR:
   (a) Trustees should have policies on how they address, in their investment decisions and in their stewardship activities, financial and non-financial factors relevant to long-term outcomes for members. This should include policies for ascertaining the views of their members.
   (b) Rigid codification of the law on fiduciary duties would be impractical. However, **clarification on a permissive basis** would not pose the same risks. The IR should include a provision clarifying that trustees may have regard to a wide range of factors, including ESG and non-financial considerations, when exercising their discretion on investment and stewardship decisions.
   (c) Trustees should have their own policies on stewardship. Requiring trustees to "comply or explain" with the Stewardship Code would not encourage them to take stewardship seriously. If the Government wants to reference a particular framework, it should reference the National Association of Pension Funds' Principles for Stewardship Best Practice.
   (d) Policies required under the IR should be meaningful. Trustees should not be allowed to produce the high-level, boilerplate statements which many pension funds currently use.

(e) Trustees should be required to explain how they will ensure that their investment managers follow their policies.
(f) Trustees should report on the implementation of their policies annually in their annual investment report.
(g) Trustees should be encouraged to publish on their fund website their SIP and annual report.
(h) If trustees do not have policies on the above, they should be required to explain why.
(i) The Government should produce clear explanatory notes on trustees' duties to the secondary legislation, in line with the Law Commission's guidance.

Context of the consultation

4. This consultation is a significant stage in a long and detailed project which arose out of the financial crisis of 2008. With cross-party recognition of the role short-termist practices played in the crash, Professor John Kay undertook a review of UK equity markets. Secretary of State Vince Cable said that Kay "*set out a clear challenge to companies, investors and Government to bring about a shift in the culture of equity markets by rebuilding relationships of trust and confidence and aligning incentives in the investment chain*"[1]. Indeed, Kay emphasised strongly the need for a *culture* of long-term decision-making, trust and stewardship to protect savers' interests. He recognised the essential role that fiduciary duties play in the promotion of such a culture and the damage being done by misinterpretations and misapplications of duties in practice. He therefore recommended that the Law Commission review the law on fiduciary duties in the investment sphere.

5. ShareAction had already identified misinterpretation and misapplication of trustees' fiduciary duties as a major barrier to prudent investment in pension fund members' interests. The lack of clarity led (and unfortunately still leads) trustees and their legal advisers to interpret their duties as requiring the maximisation of profit in the short-term. We explored this issue in detail in our publications "Protecting our Best Interests"[2] (2011) and "The Enlightened Shareholder"[3] (2012).

The Law Commission's findings

6. The Law Commission published its final report in July 2014. It confirmed that it is wrong to say that trustees are under a duty to maximise short-term profit. It looked at "financial factors", being "*any factor which is relevant to trustees' primary investment duty of balancing returns against risk*" (para. 6.35). Trustees, the Law Commission found, are able to take into account a wide range of factors:

> *Trustees may take account of any factor which is financially material to the performance of an investment,* ***including environmental, social or governance factors*** *…[and] we think the law goes further: trustees should take into account financially material factors* [emphasis added] (paras. 6.27 & 6.30).

7. The Law Commission then went on to consider "non-financial factors", which they defined as "*factors which might influence investment decisions motivated by other (non-*

[1] Page 3, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/367070/bis-14-1157-implementation-of-the-kay-review-progress-report.pdf
[2] http://shareaction.org/sites/default/files/uploaded_files/fidduty/FPProtectingOurBestInterests.pdf
[3] http://shareaction.org/sites/default/files/uploaded_files/policy/EnlightenedFiduciaryReport.pdf

financial) concerns, such as improving members' quality of life or showing disapproval of certain industries" (para. 6.33):

> *In general, non-financial factors may only be taken into account if two tests are met:*
> *(1) trustees should have good reason to think that scheme members would share the concern; and*
> (2) *the decision should not involve a risk of significant financial detriment to the fund* (para 6.34).

8. In summary, therefore, the Law Commission found that trustees' fiduciary duties mean that they:
   (a) ***should*** take into account "financial factors", including any relevant environmental, social or governance (**"ESG"**) concerns; and
   (b) ***may*** take into account "non-financial factors", such as members' ethical and quality of life concerns, subject to the two part test set out above.

   The Law Commission was not prescriptive as to how trustees should approach these factors. Trustees maintain their discretion and should take into account factors relevant to their schemes (para. 6.32).

A word on terminology

9. During the Law Commission's consultation period, there was significant discussion around terminology. Whilst those familiar with the Law Commission's report should now understand what is meant by "financial" and "non-financial", there is a risk that the use of these words in secondary legislation will cause some confusion, particularly regarding the link to ESG issues.

10. The term "non-financial" suggests something softer, removed from the question of profit. But the reality is that many ethical, moral or quality of life concerns can have a significant impact on financial return and should be factored into a long-term risk approach. And, further, some factors which we may now think of as "non-financial" may one day come to be accepted as significant risks to the financial health of portfolios (as has happened with climate change). So the division into "financial" and "non-financial" factors is an over-simplification.

11. A further possible confusion is set out a Chapter 2, paragraph 9 of the consultation paper. This mentions trustees' "*legal duties to consider financial factors, regardless of whether these may also be ethical or ESG factors*". In light of the Law Commission's findings, there is scope for confusion in describing the *same* factor as being both financial *and* ethical: under the Law Commission's terminology "ethical" factors fall more neatly into the class of "non-financial" factors.

12. The real distinction should perhaps be between the financial and the non-financial *implications* of a factor – for example, investment in tobacco may have: (1) financial *implications* (the risk of litigation or regulation impacting on the value of the investment) *or* (2) non-financial *implications* (members' dislike of being invested in the tobacco industry). We have taken this approach in our draft regulations as set out below.

The impact of the Law Commission's review

13. The Law Commission's 240 page report discusses complex legal principles and makes recommendations to Government and regulators as to how to improve understanding of the law on fiduciary duty. It seems that the Law Commission hoped that its report, along with a shorter guide for trustees[4], would continue to guide trustees and their advisers. However, it seems unlikely that parties will continue to delve into the Law Commission's report once the IR have been amended. The changes made by the Government to the IR will in practice become the "last word" on this issue for trustees and their advisers. **It is therefore critically important that the IR are amended in a way which: (i) properly reflects what the Law Commission found and (ii) encourages good practice amongst trustees.** It would not be too strong, we feel, to say that if the Government gets this stage wrong, the important work of the Law Commission will be undone.

Codification of the law on fiduciary duties

14. Before answering the consultation questions we wish to address an important misunderstanding arising out of the Law Commission's report.

15. The Law Commission concluded that the law on fiduciary duties is "*complex, difficult to find and not well known*" and that this "*may lead trustees to be overly narrow in their approach to investment factors and to their beneficiaries' concerns*" (para. 7.4). It recognised the "*strong feeling that [this uncertainty] was not simply an academic problem. The uncertainty and complexity of the law leads trustees to be risk averse, relying heavily on legal advice*" (para. 7.25).

16. The Law Commission discussed different approaches to clearing up this uncertainty, including codifying "*the general law of fiduciary duties through legislation*" (para. 7.37). It rejected this as possibly undermining the important flexibility of the law.

17. The Law Commission's discussion here is confusing. It discusses the risks posed by codification (that is, the setting out of the law as some kind of set of rules or code), but it quotes consultation responses from parties discussing statutory **clarification**, not codification. It then concludes that statutory *clarification* would not be appropriate. With respect, the Law Commission conflated codification and clarification and attributed the negative features of codification to the latter.

18. ShareAction agrees with the Law Commission that codification of the general law on fiduciary duties would be a "*lengthy and laborious process, which could have unintended consequences*" (para. 136). We do not actually think many, if any, respondents to the Law Commission's consultation were advocating this. What would be helpful and what was being suggested by respondents, was **clarification** in law.

19. Clarification would mean having in the IR a section which sets out the types of considerations and implications (financial and non-financial) which trustees ***may*** take into account when exercising their discretion in accordance with their fiduciary duty. It would not say that trustees *must* take these considerations into account. Nor would it say

[4] http://lawcommission.justice.gov.uk/docs/lc350_fiduciary_duties_guidance.pdf

that these considerations "amount to" a fiduciary duty – it would absolutely not seek to set out in law a definition of what it is to be a fiduciary. The benefits of this approach are:

(a) **Flexibility**: it does not undermine the useful flexibility of the common law on fiduciary duties. It is not an attempt to capture or define every feature of a fiduciary duty.

(b) **Clarity**: it would put into law the Law Commission's findings around financial and non-financial factors. This would mean that the amended IR would properly reflect the Law Commission's findings. This is important as it is unlikely that people will keep returning to read the Law Commission's report.

(c) **Discretion**: it allows trustees to retain their important discretion in respect of decisions. It would not *require* trustees to take the factors into account, but would be permissive.

(d) **Reassurance**: it would reassure trustees and their advisers that they may take wider factors into account than short-term returns. This is what the Law Commission found, but it also found that the complexity of the current law means that trustees are often advised to be cautious and to take a narrow view of their duties. Having a section in the IR which clarifies that this is not necessary would reassure trustees that they do have wider powers than is sometimes assumed.

Recent case studies – pension fund trustees' investment decisions

20. ShareAction came to the issue of trustees' fiduciary duties after repeated experiences of pension fund trustees stating that they believed the law to prohibit them from considering non-financial factors and ESG concerns. Out of concern not to be seen to do this, trustees took a very narrow view of their fiduciary duty, seeing it as a requirement to maximise profit in the short-term.

21. Nearly one year on from the Law Commission's final report, ShareAction is aware of continued confusion about the law on fiduciary duties. This is the case even when trustees receive advice based on the Law Commission's findings. We thought it may be helpful to set out below some case studies based on recent practices we have encountered.

The Parliamentary Contribution Pension Fund

An exchange between the trustees of the Parliamentary Contribution Pension Fund (**PCPF**) and a group of its members has recently been publicly reported[5]. Although the PCPF is set up under statute, the Law Commission's findings apply to it as to other pension funds. Members wrote to the PCPF asking about its investment in carbon-heavy industries and the assessment made in respect of the risk climate change poses to the fund. It was reported that the PCPF Chair replied that "*the trustees' lawyers had advised that for the trustees to exclude a sector would be incompatible with their 'legal and fiduciary duties of investment*'" and that "*as MPs held a wide range of views, it would be impossible they "would share a moral view viewpoint in one area of investment*".

The members challenged the chair's characterisation of climate change as a "moral viewpoint", stating that "*climate change has significant financial implications for pension funds. It is not merely a matter of morals or ethics. Accordingly, we remain concerned that a failure to acknowledge the risks of continued investment*

[5] http://www.theguardian.com/environment/2014/oct/21/divest-mps-pension-fund-from-fossil-fuels-says-caroline-lucas
http://www.theguardian.com/environment/2015/feb/17/mps-pension-fund-at-risk-from-fossil-fuel-investments-caroline-lucas-warns

in fossil fuel industries would in fact be to the financial detriment of the scheme". To this, the Chair replied that he has to "*go on the basis of advice I'm given by investment managers who are saying to the contrary. Other trustees are similarly minded, to go on the advice of our lawyers.*"

The reports of this exchange are concerning for the following reasons:

(a) Climate change is widely understood as a financially material factor – much economic research has shown the impact it could have on the financial value of investments. This has been argued by key figures such as the Governor of the Bank of England. The fact that the trustees of the PCPF and their advisers appear to have characterised it as a purely "moral" concern is troubling.

(b) Even if climate change were a "moral" issue, the trustees and their advisers appear to have misunderstood the Law Commission's findings that they are still able to take it into account, as "non-financial" factors are relevant to trustees' decisions. The Chair's view that to do so would be impossible because of the wide range of members' viewpoints runs counter to the Law Commission's lengthy discussion about seeking to understand members' views and to take into account their concerns.

(c) The fall-back response appears to be that the trustees are delegating this issue to their advisers. Of course it is appropriate for trustees to seek and to listen to advice, but the case neatly emphasises how much trustees rely on their advisers and, therefore, the importance of those advisers having clear guidance in law about the full nature of trustees' duties.

Local authority pension funds

In an update to a local authority pension fund, Hymans Robertson LLP discussed the issue of investment in tobacco. They summarised the action taken by different local authority pension funds and stated that in January 2015 "*one local authority pension fund sought legal opinion regarding the impact of investing in tobacco companies. The conclusion of the review was that* ***the fiduciary duty of the pension fund committee was to maximise profits of the pension fund*** *and that they cannot legally withdraw from tobacco investments* [Emphasis added]."

The fund in question must have been advised based on the Law Commission's report. It is of course possible that even whilst taking full heed of the Law Commission's guidance trustees could conclude that it is not appropriate to divest from tobacco. However, what is concerning is the statement that complying with fiduciary duty *requires* the maximisation of profits (and, impliedly, to the exclusion of any other considerations). This is not what the Law Commission found. This demonstrates the continued confusion in this sphere.

Large pension funds

ShareAction has been working with members of a number of large pension funds who wish to understand better their funds' investment decisions and how their money is invested. The process has been lengthy and time-consuming, and not one which could easily have been untaken by members working alone. The trustees have at times appeared reluctant to engage with members and to see members' concerns as irrelevant to their work. This is unfortunate given the Law Commission's discussion of trustees taking members' views into account: although not a legal imperative, it is something which trustees may do and is arguably part of the test for the consideration of non-financial factors.

The above discussion provides important context to our responses to the questions asked in the consultation paper, to which we now turn.

Responses to consultation questions

Question 1: How could regulation 2(3)(b) of the Investment Regulations be amended so that it more clearly reflects the distinction between financial and non-financial factors?

22. The Law Commission focussed in particular on regulation 2(3)(b)(vi) which refers to any policy the trustees may have on "social, environmental or ethical" (**"SEE"**) considerations.

23. It is helpful to look at what types of practice arise out of the IR as currently drafted. ShareAction undertakes regular surveys of the pension industry. Our focus on the UK's largest occupational pension funds in 2013 involved an extensive review of their policies on responsible investment, including looking at their Statements of Investment Principles (**"SIP"**)[6]. Here is a typical example of how a large fund addresses regulation 2(3)(b)(vi):

> *Investment policy*
> *The Trustee ...[has] delegated all day-to-day decisions about the investments that fall within each mandate to the relevant fund manager through a written contract. These duties include:*
> ...
>> *Taking into account social, environmental, and ethical considerations in the selection, retention and realisation of investments in so far as this is consistent with their overall objectives.*
>
> ...
>
> *The Trustee...expect[s] the fund managers to manage the assets delegated to them under the terms of their respective contracts and to give effect to the principles in this statement so far as is reasonably practical.*

24. There is very little of substance in this SIP. Like many SIPs it uses generic wording. It is hard to see how this "policy" can usefully be guiding the trustees in their decisions. It is also hard to see how the trustees can be held to account for the decisions they make. As is very typical in this area, it is clear that the trustees have delegated all these considerations to their managers, but it is not clear how they seek to ensure that the managers implement the trustees' policies (if they exist) on SEE factors.

25. **Any changes to the IR made by the Government should seek to ensure that trustees develop meaningful and effective policies and do not continue making high-level, boilerplate statements which do very little to either protect members' interests or allow them to evaluate their trustees' effectiveness on SEE factors.**

[6] http://www.shareaction.org/sites/default/files/uploaded_files/investorresources/Entrusted_with_our_future_final.pdf

Proposed solution

26. **The Government should require trustees to develop and state policies on how they address, in their investment and in their stewardship activities, financial and non-financial factors relevant to long-term outcomes for members**.

27. It is important to note that such policies should cover investment **and** stewardship. ShareAction is concerned that the way in which the consultation paper is structured (with question 1 addressing financial and non-financial factors and question 2 addressing stewardship) suggests that ESG and wider non-financial factors are not relevant to stewardship, which is incorrect. We discuss this further later in response to question 2.

28. In developing and stating these policies on investment and stewardship, trustees should:
    (a) identify any specific financial or non-financial factors they have decided to address and how;
    (b) state their policies / proposals for ascertaining the views of members in respect of these investment and stewardship decisions (e.g. surveys, consultations, meetings with members); and
    (c) explain how they ensure that those to whom they delegate investment, management or stewardship responsibility will follow the trustees' policies, and how they will select, mandate and monitor agents in this respect.

29. In recognition of the fact that the Law Commission did not **require** trustees to take an ESG approach, but said that they maintain their overall discretion to look at the relevance of factors, we have not suggested in our draft legislation that the IR mandate that trustees have a policy, but have instead reflected the existing drafting in regulation 2(3) of "their policy (if any)". However, ShareAction believes that trustees should have such policies in place and therefore we suggest **that the IR should require trustees to explain why, in the event that they lack any policy we have advocated.**

30. **The point regarding consulting members is important.** The Law Commission's test for taking into account non-financial factors is that trustees have **good reason** to think that members would share the concern. Trustees should also, however, be required to state their policies on ascertaining members' views on **financial** matters: the Law Commission's report confirmed the principle that trustees may consult their beneficiaries (paras. 3.53 & 3.54). The Government should include this in the IR in order to properly reflect the Law Commission's findings. It would also help to clarify for trustees that they are able to seek to understand members' views (whilst of course ensuring that their discretion is not fettered).

31. The purpose of the above is to ensure that trustees are required to develop meaningful policies - policies which set out detail about how trustees address ESG and wider factors and to which they can be held. Given that in practice many trustees will delegate this work to their managers, **it is important that the policies require trustees to explain how their agents will follow the policies.**

32. In order to ensure that trustees take this seriously and reflect on how well they are adhering to the policies, **they should be required to report on the implementation of their policies annually, including identifying and explaining particular long-term risks.** This reporting should take place in the annual investment report.

33. ShareAction also thinks that it is important that trustees **be encouraged to publish on any website their SIP and their annual report**, as this is a tool for increasing transparency and accountability which is underused.

Draft legislation

34. At the end of this response, we have set out a draft of full regulations amending the IR. However, set out below is an amended version of the current IR as relevant to Question 1 and the discussion above. It shows our suggested changes in red. For commentary and reasoning behind the changes highlighted green, see our response to question 2:

A statement of investment principles must be in writing and must cover at least the following matters –

(a) the trustees' policy for securing compliance with the requirements of section 35 of the [Pensions Act 1995] (choosing investments);

(b) their policies in relation to –
   i. the kinds of investments to be held;
   ii. the balance between different kinds of investments;
   iii. risks, including the ways in which risks are to be measured and managed;
   iv. the expected returns of investments; and
   v. the realisation of investments.~~; and~~
   ~~vi. the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments; and~~

~~(c) their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to the investments.~~

(c) their policy (if any) in relation to the stewardship of investments, including (without limitation) whether it is part of any such policy
   i. to subscribe to the Stewardship Code published by the Financial Reporting Council, as amended from time to time; and
   ii. to comply with the Principles for Stewardship Best Practice published by the National Association of Pension Funds, as so amended;

(d) their policy (if any) in relation to the taking account of
   i. the financial implications of environmental, social and governance factors; and
   ii. non-financial factors;

   in the exercise of their powers of investment, including any specific factors which are to be taken into account;

(e) their policy (if any) in relation to their ascertaining of the views of members and beneficiaries regarding the exercise of their powers of investment and in relation to their taking such views into account (including any related consultation procedures);

(f) their policy (if any) in relation to how they select, mandate and monitor any person to whom they delegate any investment functions so as to secure the effective implementation by that delegate of any such policies are as described in sub-paragraphs (c) to (e);

(g) whether it is the trustees' policy to publish on a website freely accessible to members and beneficiaries
   i. a copy of their current statement of investment principles; and
   ii. a copy of the latest annual investment report required under paragraph 30 of schedule 3 to the Occupational and Personal
   iii. Pension Schemes (Disclosure of Information) Regulations 2013; and

(h) where the trustees have no such policy as is described in sub-paragraph (c), (d), (e), (f) or (g) above or where any policy in relation to the stewardship of investments does not include the specific steps described in sub-paragraph (c), the reasons why.

35. The relevant new definitions for the above would be set out in the regulations as follows:

> "beneficiary" has the same meaning as under regulation 4(11)
>
> "benefit" includes –
> (a) financial benefit provided out of investments; and
> (b) any other benefit that the trustees or delegated fund manager consider can be conferred on members and beneficiaries without a risk of significant financial detriment to the portfolio as a whole, including, without limitation, any benefit relating to any non-financial factor to which they may have regard under [*ShareAction's suggested draft reg 4A(2)(e) – see discussion below*];
>
> "non-financial factors" means factors which might influence investment decisions motivated by non-financial concerns including (without limitation) –
> (a) members' and beneficiaries' quality of life;
> (b) the social and ethical views of members and beneficiaries;
> (c) the impact of any exercise of investment powers or discretion on communities and the environment; and
> (d) the impact of any such exercise on the financial system and the economy as a whole,
> whether or not the factor in question has also any financial implications for the portfolio as a whole
>
> "powers of investment" means powers relating to any investment functions including (among other matters) –
> (a) the selection, retention and realisation of investments; and
> (b) the stewardship of investments; and
>
> "stewardship of investments" includes (without limitation) the promotion of the long-term success of investees companies through
> (i) the exercise of rights, including voting rights, attaching to investments and
> (ii) engagement with corporate management.

The need for clarification on fiduciary duties

36. We note the call for views at Chapter 2 paragraphs 11 and 12 "*on whether amendments to regulation 2(3)(b) of the [IR] could be made in such a way as to provide appropriate clarity for trustees regarding legal duties [to consider a range of factors when formulating their investment strategies]*".

37. In its Progress Report on the implementation of the Kay Review, the Government noted that "*a number of stakeholders have suggested that it would be appropriate to include in the [IR] a specific statement clarifying that trustees should consider any factors which may be material to financial interests of scheme members and beneficiaries, including long-term factors, and determine what weight should be attached to these factors in their investment decisions.*"[7]

38. The fact that stakeholders have said to the Government that this type of statement is needed shows that there is still real confusion about the legal position. This reflects the Law Commission's own findings that the law on fiduciary duties is "*complex, difficult to find and not well known*". In developing policy and law in this area, the Government must think about how to provide clarity as well as a reference point to which concerns about the nature of trustees' duties can be directed. As set out above in the case studies, there is still

[7] Page 28, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/367070/bis-14-1157-implementation-of-the-kay-review-progress-report.pdf

much confusion on this issue, even since the Law Commission's report. Until this confusion is cleared up, it is impossible to see how this area of trustees' duties can progress to actually encouraging trustees to exercise their fiduciary duties rather than falling back on the narrow pursuit of short-term profit.

Why permissive clarification is appropriate

39. As discussed above at paragraphs 15 to 19, ShareAction believes that the Law Commission erred in its understanding of the difference between codification and clarification. We are not advocating the rigid codification of the general law of fiduciary duties.

40. ShareAction believes that **the IR should be amended to include a provision that trustees (or their delegated managers, who in practice will make many decisions in this area) *may* have regard to a range of factors, including ESG and non-financial considerations, when exercising their discretion on investment and stewardship decisions.**

41. It may be helpful to explain why we advocate the use of the word "may" in our draft legislation (set out in full below), especially as The Law Commission's position is sometimes incorrectly summarised as **requiring** trustees to take into account ESG factors.

42. The Law Commission found that trustees should take into account financially material factors. Some of these factors, it recognised, may be ESG factors. However, it said that it did not think that it would be helpful "*to say that ESG or ethical factors **must always** be taken into account*" (para. 6.31 - emphasis added). Trustees maintain their discretion, acting on proper advice, to look at the factors relevant to particular decisions and to weigh up the relevant risks associated with the factors before making a decision in the round.

43. Our suggested changes to the IR below maintain the flexibility of the law, and trustees' discretion, by clarifying the factors which trustees may consider when making decisions. These are the factors which the Law Commission itself discussed (paras 6.39 to 6.56). This is one way in which permissive clarification is different to the rigid codification the Law Commission appeared to have in mind when discussing the risks associated with drafting legislation on fiduciary duties. Instead of rigidly binding trustees to one course of action, **our permissively drafted regulation is a mechanism for providing reassurance to trustees, their agents and advisers**, who appear to be concerned about trustees taking account of wider factors. It would be something to which they could refer when thinking about an ESG or "ethical" issue and it would help to reassure them that they may be able to take this into account. We refer back to paragraph 19 above for the further benefits of such an approach.

44. **In order to assist with the interpretation of any such changes to the IR, we recommend that the Government produces clear explanatory notes to the secondary legislation along the above lines.**

Draft legislation

45. ShareAction suggests the inclusion in the IR of a section along the following lines (with definitions as above). It should be noted that this section mirrors s.172 of the Companies Act 2006, which sets out directors' wider duties. However, unlike s.172 the following section is drafted on a permissive not prescriptive basis (the "musts" in subsection (1) and

(2) refer to uncontroversial elements of trustees' fiduciary duties, such as the requirement to act in beneficiaries' best interest – the key permissive "may" is highlighted in bold):

> **4A**
>
> (1) The trustees of a trust scheme must exercise their powers of investment, and any fund manager to whom any discretion has been delegated under section 34 of the 1995 Act (power of investment and delegation) must exercise the discretion, in accordance with the following provisions of this regulation.
>
> (2) The powers of investment or delegated discretion must be exercised in the way the trustees or delegated fund manager consider, in good faith, would be most likely to be for the benefit of the members and beneficiaries as a whole and to be fair as between the members and beneficiaries, including as between present and future members and beneficiaries. In so exercising any powers or discretion, the trustees or delegated fund manager **may** have regard (among other matters) to:
>
> a. the likely financial consequences of any such exercise in the long term;
> b. the financial impact of any such exercise on the portfolio as a whole;
> c. the impact of any such exercise on the financial system and the economy where such impact has financial implications for the portfolio as a whole;
> d. the implications of environmental, social and governance factors for return on investments; and
> e. non-financial factors provided that the trustees or delegated fund manager have good reason to think that members and beneficiaries would share a concern about a particular factor.
>
> (3) Nothing in this regulation shall be interpreted as affecting any provisions in any instrument or agreement that confer on the trustees any wider powers than those set out in this regulation, including (without limitation) any powers to prioritise non-financial factors over financial considerations.

Question 2: Do you agree that amending the Investment Regulations to require trustees to comply with the current requirements in the Stewardship Code or explain why they have not done so, is the most appropriate way to implement the Law Commission's recommendation? If not, what approach would be more appropriate to encourage trustees to consider their approach to stewardship?

46. ShareAction is concerned that the way the consultation paper is structured suggests that the question of ESG and non-financial factors (and the need for trustees to be empowered in respect of their duties here) is not relevant to the issue of stewardship. This is incorrect – ESG and non-financial factors are relevant to trustees' approaches to stewardship and to investment. However, the separation of these issues in the paper risks encouraging a "silo" approach to stakeholders' responses.

47. Stewardship by pension fund trustees and their agents is very important. As the Law Commission stated "*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 think 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*" [emphasis added] (para. 5.98). There should be no doubt that taking an interest in the long- term success of investee companies is part of trustees' fiduciary duty to act in beneficiaries' best interests.

48. Professor Kay recognised the importance of good stewardship to the success and stability of UK equity markets, describing it as "key" to the equity investment chain[8]. Stewardship, Kay argued, is **the** critical value-creating activity in modern markets:

> *Promoting stewardship and good corporate governance is not an incidental function of equity markets. The effectiveness of modern equity markets depends almost entirely on their effectiveness in promoting these goals of stewardship and governance.*[9]

ShareAction urges the Government to amend the IR to underline the importance of, and to encourage the development of, pension fund trustees' vital stewardship role.

49. **The Government should make changes to the IR to encourage trustees to have a policy on stewardship.** Such a policy should cover matters and practices relevant to the way pension trustees engage with companies in practice, which for many will be a matter of delegation to their managers (in-house or external).

50. **The suggested solution that trustees should be required to "comply or explain" with the Stewardship Code would not encourage trustees to take stewardship seriously.** Put bluntly, it would be unlikely to achieve anything meaningful in the majority of cases. This is because:
    - (a) The Stewardship Code is not written for pension trustees. Although some asset owners do sign up to the Code, it does not set out the legal framework within which trustees exercise their stewardship role, nor should it be expected to do so as it was not designed with pension funds in mind;
    - (b) if the requirement is simply to "comply or explain" with the Code, in practice we will see statements such as "the trustees delegate this to their managers". This reveals nothing about their approach to stewardship or how they exercise oversight of managers; and
    - (c) ShareAction has recently undertaken an extensive review of how the UK's top 30 asset managers apply the Code[10]. We found that practices amongst the majority of signatories was in fact very poor – with little or no information being disclosed or with reams of complicated or incomplete data being shared. If this practice is replicated by pension trustees (and it seems likely that it will be, as the Code is not rigorously drafted or enforced) then having them "comply or explain" will have done nothing to encourage good practice.

51. The above points can be best illustrated by a real-life example. We mentioned above the Parliamentary Contribution Pension Fund's discourse with members about climate change. In the interests of consistency, we look here at the same fund's statement of compliance with the Stewardship Code. We stress that this is (unfortunately) a very typical statement; we could have chosen a similar example from any number of funds.

52. The full statement can be found here: PCPF. For the majority of the Principles, the trustees make statements like the following:

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[8] Para. 6.2, The Kay Review, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf
[9] Para 2.32, Ibid
[10] http://shareaction.org/sites/default/files/uploaded_files/AssetManagerBenchmarkSurvey2015.pdf

The Fund's investment managers take direct responsibility for stewardship issues, and voting and engagement in the investments…

Day-to-day responsibility for managing the Fund's equity holdings is delegated to the appointed investment managers…

Responsibility for day-to-day interaction with companies is delegated to the Fund's investment managers…

The Fund has delegated to its investment managers responsibility for voting and engagement in relation to the investments which they manage…

With respect, the value of these statements, and the overall statement of compliance, is limited. What is a pension fund member seeking to understand how his money is being used to gleam from these? One wonders how much impact the making of these statements has had on the way in which trustees approach their stewardship obligations. While we recognise that it may be appropriate for trustees to delegate these areas of work – and indeed, it may serve members' interests better for the day-to-day work to be done by experienced managers –we think it is possible to develop a better framework to reflect trustees' stewardship duties, one that encourages trustees to monitor and manage the activity they have delegated.

53. **The IR should be amended to encourage good practices reflective of the way in which trustees actually undertake stewardship.** This means requiring them to have a policy addressing practices such as: setting stewardship objectives; identifying the ESG and non-financial factors they will address; including stewardship practices in manager selection, mandates and monitoring; actively encouraging managers to engage with companies; and reporting clearly to members on stewardship.

54. ShareAction does not think the above will be achieved by simply requiring reference to the principles of the Stewardship Code. **The Government should encourage trustees to have their own policy on stewardship. If the Government wants to reference a particular framework, it should also reference the National Association of Pension Funds' Principles for Stewardship Best Practice**[11]. These principles properly reflect the way in which stewardship works for pension trustees and addresses the points set out above.

55. As with our suggestions regarding policies on investment, **if the trustees do not have such a policy they should be required to explain why. Trustees should be required to report on how the policy has been implemented,** including identifying and explaining particular long-term risks. This should take place in the annual investment report.

Draft legislation

56. We set out above our suggested amendments to regulation 2(3)(b). These included (in green) sections on stewardship policies. For ease of reference, we have reproduced these stewardship sections out below:

[11] http://www.napf.co.uk/~/media/Policy/Documents/0272b-NAPF-Stewardship-Policy.pdf

…

(c) their policy (if any) in relation to the stewardship of investments, including (without limitation) whether it is part of any such policy

i. to subscribe to the Stewardship Code published by the Financial Reporting Council, as amended from time to time; and

ii. to comply with the Principles for Stewardship Best Practice published by the National Association of Pension Funds, as so amended;

…

(h) where the trustees have no such policy as is described in sub-paragraph (c), (d), (e), (f) or (g) above or where any policy in relation to the stewardship of investments does not include the specific steps described in sub-paragraph (c), the reasons why.

[From the draft definitions above:]

"stewardship of investments" includes (without limitation) the promotion of the long-term success of investees companies through

(i) the exercise of rights, including voting rights, attaching to investments and

(ii) engagement with corporate management.

57. The permissive clarification we have suggested as a new regulation 4A would also apply to trustees' decisions on stewardship.

58. The definition of "stewardship of investments" is based on (i) the Law Commission's definition of stewardship in paragraph 5.82 of their report and (ii) the existing regulation 2(3) (c) of IR, relating to the exercise of shareholder rights, which it would incorporate and replace.

Disclosure and reporting

59. In relation to both consultation questions we have stressed the need for trustees to have to report on the implementation of their policies. We have identified the scheme's annual investment report (required under the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 (the "**DR**")) as the most appropriate mechanism for this reporting. Annual reporting is appropriate because trustees should be encouraged to (i) review the effectiveness of their policies and (ii) be accountable to members in respect of their decisions no less frequently than annually.

60. **As the DR mirror (at Schedule 3, paragraph 30(d) and (e)) the wording of reg. 2(3)(b)(vi) and 2(3)(c) of the IR, we assume that at least consequential amendments will be needed to the DR as a result of the Government's changes to the IR**. With regard to the suggested replacement of regulation 2(3)(c), see paragraph 58 above. In light of this, ShareAction believes that the Government should take the opportunity to improve trustees' reporting by providing that the investment report more closely resemble companies' narrative reports. The report should set out:

(a) how the scheme has implemented its investment and stewardship policies (including any related consultations with members), with explanations for any departures from the SIP and planned remedial actions; and

(b) how the scheme is managing long-term risks to beneficiaries' best investments and to their wider best interests, in accordance with the trustees' fiduciary duties.

61. As set out at paragraph 33 above and in our draft regulations, we believe trustees should be encouraged to state in their SIP whether the SIP and investment report are available on the fund's website and, if not, why not.

62. Our full draft amending regulations set out at the appendix to this response include suggested amendments to the DR in line with the above.

Question 3: What steps would trustees need to take to comply with any amendments to the Investment Regulations, as set out in Chapter 2? What, if any costs, would be involved in meeting any new requirements?

63. ShareAction's suggested amendments would require trustees to develop policies, for example on taking into account ESG and wider non-financial factors, on consulting with members and on stewardship practices. It seems reasonable to allow trustees a grace period to develop these. We suggest that 1 year would be reasonable, as this was the approach taken to the implementation in 2000 of the original changes to the 1996 Investment Regulations now contained in regulations 2(3)(b)(vi) and 2(3)(c) of the IR.

64. Regarding our suggestions around disclosures to be made in annual investment reports, it seems reasonable that these be required to happen in the first annual report after the expiration of the grace period.

65. **We do not anticipate significant costs being incurred by trustees developing their policies. Any costs should be set against the long-term costs of not implementing workable reform in this area**, including:
    (a) the continued confusion about what trustees can and cannot take into account – with associated fees to legal advisers for repeated analysis of trustees' duties;
    (b) the wider significant costs to the economy of trustees continuing to focus narrowly on short-term return, the exact type of behaviour identified by Professor Kay as a cause of the most recent financial crash;
    (c) the likely decreased value of members' pension savings if trustees do not take account of ESG factors, such as climate change, in their investment and stewardship decisions[12]; and
    (d) the wider negative impacts on society if the £3 trillion invested in UK pensions is invested in a manner which is not in the best interests of savers.

66. We understand that a similar approach to impact assessment was taken by the Government in relation to the new directors' duties introduced under section 172 of the Companies Act.

Social investments

67. We note the Government's appetite for encouraging the growth of social investments (page 5 of the consultation paper). The policies and clarifications we have suggested above should enable trustees to understand the extent to which their fiduciary duties allow them to take account of the social impact of investments as a factor relevant to their members' interests.

[12] Deutsche Bank undertook a "meta" study in 2012 of studies of the impact of taking ESG factors into account. It found that across the board investments performed better when "responsibly" invested https://institutional.deutscheawm.com/content/_media/Sustainable_Investing_2012.pdf

General comments on the consultation

68. The consultation asks stakeholders to suggest changes to the IR. It does not include any draft amending regulations. This has made responding challenging, and may well have put off potential respondents who did not feel able to submit draft legislation from scratch. Drafting legislation is a difficult skill and suggestions put forward by stakeholders may be hampered by their inexperience with this. We believe that it is important that when considering responses, the Government looks beyond suggested drafting, including ShareAction's, at stakeholders' underlying proposals and intent.

69. It would have been better if the consultation had included draft legislation on which to comment. Disappointingly, it appears from the statement at Chapter 3, paragraph 1 that stakeholders will not have an opportunity to comment on such a draft before the Government lays regulations in 2016. This is unsatisfactory as it limits the meaningful engagement by stakeholders. We hope that this will not be repeated for future consultations, including those planned in relation to greater transparency.

70. We would like to reiterate our point at paragraph 46 above about the structure of the consultation paper and the risk of a "silo" approach being encouraged.

APPENDIX
Composite draft amending regulations

2015 No. [ ]

PENSIONS

The Occupational Pension Schemes (Investment and Disclosure of Information) (Amendment) Regulations 2015

Made	[ ]
Laid before Parliament	[ ]
Coming into force	[ ]

The Secretary of State for Work and Pensions makes the following Regulations in exercise of the powers conferred by [*Here insert relevant powers: these would include section 113 of the Pension Schemes Act 1993 and section 35 of the Pensions Act 1995*.].

In accordance with section 185(1) of the Pensions Schemes Act 1993 and section 120(1) of the Pensions Act 1995 [*Here insert any further relevant consultation provisions*.], the Secretary of State has consulted with such persons as the Secretary of State considers appropriate.

1. **Citation, commencement and interpretation**

    1. These Regulations may be cited as the Occupational Pension Schemes (Investment and Disclosure of Information) (Amendment) Regulations 2015 and shall come into force on [ ].
    2. In these Regulations –

    "the Investment Regulations" means the Occupational Pension Schemes (Investment) Regulations 2005; and
    "the Disclosure Regulations" means the Occupational and Personal Pensions Schemes (Disclosure of Information) Regulations 2013.

2. **Amendments to the Investment Regulations**

1. Regulation 2 (Statement of investment principles) of the Investment Regulations is amended as follows –
    a. at the end of sub-paragraph (3)(b)(iv) insert "and";
    b. at the end of sub-paragraph (3)(b)(v) delete "; and" and substitute a full stop;
    c. omit sub-paragraphs (3)(b)(vi) and (3)(c); and
    d. after sub-paragraph (3)(b)(v) insert –

    "(c)their policy (if any) in relation to the stewardship of investments, including (without limitation) whether it is part of any such policy
        i. to subscribe to the Stewardship Code published by the Financial Reporting Council, as amended from time to time; and
        ii. to comply with the Principles for Stewardship Best Practice published by the National Association of Pension Funds, as so amended;

    (d) their policy (if any) in relation to the taking account of
        i. the financial implications of environmental, social and governance factors; and

ii. non-financial factors;

in the exercise of their powers of investment, including any specific factors which are to be taken into account;

(e) their policy (if any) in relation to their ascertaining of the views of members and beneficiaries regarding the exercise of their powers of investment and in relation to their taking such views into account (including any related consultation procedures);

(f) their policy (if any) in relation to how they select, mandate and monitor any person to whom they delegate any investment functions so as to secure the effective implementation by that delegate of any such policies are as described in sub-paragraphs (c) to (e);

(g) whether it is the trustees' policy to publish on a website freely accessible to members and beneficiaries

i. a copy of their current statement of investment principles; and
ii. a copy of the latest annual investment report required under paragraph 30 of schedule 3 to the Occupational and Personal
iii. Pension Schemes (Disclosure of Information) Regulations 2013; and

(h) where the trustees have no such policy as is described in sub-paragraph (c), (d), (e), (f) or (g) above or where any policy in relation to the stewardship of investments does not include the specific steps described in sub-paragraph (c), the reasons why.

(4) In this regulation "beneficiary", "non-financial factors", "powers of investment" and "stewardship of investments" have the same meanings as in regulation 4A.".

2. After regulation 4 (Investment by trustees) of the Investment Regulations insert –

"4A - Investment by trustees: further provisions

1. The trustees of a trust scheme must exercise their powers of investment, and any fund manager to whom any discretion has been delegated under section 34 of the 1995 Act (power of investment and delegation) must exercise the discretion, in accordance with the following provisions of this regulation.

2. The powers of investment or delegated discretion must be exercised in the way the trustees or delegated fund manager consider, in good faith, would be most likely to be for the benefit of the members and beneficiaries as a whole and to be fair as between the members and beneficiaries, including as between present and future members and beneficiaries. In so exercising any powers or discretion, the trustees or delegated fund manager may have regard (among other matters) to:

a. the likely financial consequences of any such exercise in the long term;
b. the financial impact of any such exercise on the portfolio as a whole;
c. the impact of any such exercise on the financial system and the economy where such impact has financial implications for the portfolio as a whole;
d. the implications of environmental, social and governance factors for return on investments; and
e. non-financial factors provided that the trustees or delegated fund manager have good reason to think that members and beneficiaries would share a concern about a particular factor.

3. Nothing in this regulation shall be interpreted as affecting any provisions in any instrument or agreement that confer on the trustees any wider powers than those set out in this regulation, including (without limitation) any powers to prioritise non-financial factors over financial considerations.

4. In this regulation –

"beneficiary" has the same meaning as under regulation 4(11)

"benefit" includes –
(a) financial benefit provided out of investments; and
(b) any other benefit that the trustees or delegated fund manager consider can be conferred on members and beneficiaries without a risk of significant financial detriment to the portfolio as a whole, including, without limitation, any benefit relating to any non-financial factor to which they may have regard under sub-paragraph (2)(e);

"non-financial factors" means factors which might influence investment decisions motivated by non-financial concerns including (without limitation) –
(a) members' and beneficiaries' quality of life;
(b) the social and ethical views of members and beneficiaries;
(c) the impact of any exercise of investment powers or discretion on communities and the environment; and
(d) the impact of any such exercise on the financial system and the economy as a whole,
whether or not the factor in question has also any financial implications for the portfolio as a whole

"powers of investment" means powers relating to any investment functions including (among other matters) –
(a) the selection, retention and realisation of investments; and
(b) the stewardship of investments

"stewardship of investments" includes (without limitation) the promotion of the long-term success of investees companies through
(i) the exercise of rights, including voting rights, attaching to investments and
(ii) engagement with corporate management."

3. In sub-paragraph (1)(a) of regulation 8 (Modification of regulation 2 in respect of wholly-insured schemes) of the Investment Regulations, after "sub-paragraphs (b)" omit "and (c)" and substitute "to (g)".

3. Amendments to the Disclosure Regulations

Schedule 3 to the Disclosure Regulations is amended as follows –
(a) omit paragraph 30 and;
(b) substitute the following –

"30. Where the scheme is one to which section 35 of the 1995 Act applies, a strategic investment report which has as its purpose to inform members and beneficiaries of the scheme and help them assess how the trustees of the scheme and any fund manager to whom any discretion has been delegated under section 34 of the 1995 Act (power of investment and delegation) have performed their duties in relation to their investment functions and which contains –

(a) a fair review of the investment performance of the scheme's fund –
  (i) during the year, and
  (ii) except where the scheme has existed for less than three scheme years, during a period of not less than 3 and not more than 5 scheme years ending with the year,

including an assessment of the nature, disposition, marketability, security and valuation of the scheme's assets,

(b) as part of the required review, a balanced and comprehensive analysis of the extent to which the trustees or fund manager have implemented all investment or stewardship policies contained in the statement of investment principles governing decisions about investments required under section 35 of the 1995 Act (including any related consultation procedures with members and beneficiaries), which contains –

  (i) a statement by the trustees or the fund manager providing details of any investments made or held during the year that were not made or held in accordance with any investment policy contained in the statement of investment principles, giving the reasons why and explaining what action (if any) it is proposed to take or has already been taken to remedy the position,
  (ii) a statement by the trustees or fund manager providing details of any acts or omissions on their part during the year, including (without limitation) any exercise or non-exercise of voting rights attaching to investments, that were not in accordance with any stewardship policy contained in the statement of investment principles, giving the reasons why and explaining what action (if any) it is proposed to take or has already been taken to remedy the position, and
  (iii) where no such remedial action as is described in sub-paragraph (i) or (ii) is proposed or has been taken, a statement by the trustees or fund manager giving the reasons why,

(c) as part of the required review and to the extent necessary for an understanding of the implementation of the statement of investment principles, an analysis using –
  (i) financial key performance indicators, and
  (ii) where appropriate, other key performance indicators relating to non-financial matters, and

(d) a description of the principal risks and uncertainties facing the scheme's fund, including the main financial and non-financial trends and factors likely to affect future investment performance or the wider interests of members and beneficiaries in the long term, and information about any policies of the trustees or fund manager in relation to those matters and the effectiveness of those policies.".

[Signed by the Secretary of State and dated]