ShareAction
the movement for Responsible Investment

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Dear Sirs,

Governance and administration of occupational defined contribution trust-based schemes
ShareAction's response to Part 1 of the consultation

We would like to respond to the above consultation paper relating to the Draft Code of Practice no. 13: Governance and administration of occupational defined contribution trust-based schemes (the "Code"). ShareAction is a registered charity established to promote transparency and Responsible Investment ("RI") practices by pension funds and other institutional investors. We are a member organisation and count amongst our members well-known NGOs and charitable foundations, as well as over 35,000 individual supporters.

We were very pleased to note some important and positive developments in the draft Code, including: reference to the need for trustees to have a process in place to encourage scheme members to make their views known on matters that affect them; and confirmation of the Pensions Regulator's expectation that trustee boards should "take account of risks affecting the long-term financial sustainability of the investments" when setting investment strategies. We have identified some additional points for inclusion and are submitting these under Part 1 of the consultation response form, as set out below. We note that some of the points we identify may be covered in the guidance rather than the Code itself, and that the Pensions Regulator will be also be consulting on the guidance to the Code. We will respond to this second consultation at the appropriate time.

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Part 1: Do you consider that any important areas have been missed in the new code? In responding to this question, please also consider whether any risks have been overlooked, regardless of whether any such risks were addressed in the existing code.

<u>The Trustee Board</u>

Paragraph 18

The draft Code refers to the requirement for trustees "to act in accordance with their fiduciary duties to the beneficiaries of the scheme". In our view, the Code should confirm (or refer to the Law Commission's guidance[1] confirming) 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 a two-part test:

  i. trustees should have good reason to think that scheme members would share the concern; and
  ii. the decision should not involve a risk of significant financial detriment to the fund.

The Law Commission's 240-page report[2] discusses complex legal principles and makes recommendations to Government and regulators as to how to improve understanding of the law on fiduciary duty. This report was not intended to be a guide for trustees. For trust-based DC schemes, the Pension Regulator's DC Code will be the first and most important resource.

The Department for Work and Pensions (the "DWP") responded to its consultation on the Law Commission's guidance in November 2015 to state that it would not amend the Occupational Pensions Schemes (Investment) Regulations 2005 (the "Investment Regulations") to reflect the Law Commission's findings, due to a stated lack of consensus among consultation respondents.[3] The DWP suggested that the Pensions Regulator would be incorporating the Law Commission's findings in the new DC Code and Guidance. It is therefore essential that the Pensions Regulator uses the opportunity of consulting on the new DC Code to (i) properly reflect what the Law Commission found and (ii) encourage good practice amongst trustees.

To underline the importance of this point, the European Commission has published a report commissioned from Ernst & Young to provide clarification and policy advice on the integration of environmental and resource efficiency issues into the fiduciary duties of institutional investors across the European Union. This report specifically stated that national authorities (with support from the EU Commission) should provide official guidance and interpretation of fiduciary duties and the extent to which institutional investors may include ESG issues into their investment strategies and decisions. This is to

[1] Law Commission (July 2014), *Is it always about the money?*. Available online from: http://www.lawcom.gov.uk/wp-content/uploads/2015/03/lc350_fiduciary_duties_guidance.pdf. Last accessed 29 January 2016.
[2] Law Commission (July 2014), *Fiduciary Duties of Investment Intermediaries*. Available online from: http://www.lawcom.gov.uk/wp-content/uploads/2015/03/lc350_fiduciary_duties_guidance.pdf. Last accessed 29 January 2016.
[3] DWP (November 2015) *Better Workplace Pensions: Reducing regulatory burdens, minor regulation changes, and response to consultation on the investment regulations,* Paragraph 20, Chapter 5. Available online from: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/476447/reducing-regulatory-burdens-and-misc-regs-nov-2015-consultation.pdf. Last accessed 29 January 2016.

provide a reference document and put beyond doubt the question of ESG issues and fiduciary duties.

We also feel it is important that the Code or guidance provides some clarity on the difference between ethical fund options (where members choose not to have money in, for example, tobacco or the arms trade for ethical reasons) and ESG factors which are financially material factors, such as climate change. In our experience, not all trustees are well versed in this distinction, seeing all ESG issues as ‘ethical’ and failing to engage properly with their financial implications.

Paragraph 20

The draft Code refers to the expectation that trustees “act in the interests of the members and beneficiaries of the scheme”. We believe it is important to clarify that members' interests are not purely "financial". By this, we mean the recognition by the Law Commission that members have an interest in how (a) financially material ESG issues are addressed; and (b) their non-financial concerns such as quality of life are addressed. This is in line with the two-part test outlined above.

Paragraph 36

We are pleased to see references to the need for trustees to have a process in place to encourage scheme members to make their views known on matters that affect them. Waitzer and Sarro note in the *Rotman International Journal of Pension Management* that the Duty of Impartiality, a component of fiduciary duty, requires trustees to weigh up the interests of different beneficiaries and balance them evenly.[4] This means the processes and outcomes of trustees’ decision making must incorporate due regard for different beneficiaries’ interests:

The idea of giving beneficiaries a voice accords with fiduciary law. It helps fiduciaries to fulfil their duties of loyalty and care by improving their understanding of the interests and preferences of beneficiaries.[5]

However, we feel it is essential, whether here or in the guidance, to suggest ways in which trustees can do this. Some concerns were expressed in discussions at the Pensions Regulator’s DC Code stakeholder consultation about what mechanisms are available for fulfilling this obligation and how they could be used in practical terms. We stand ready to assist by providing examples and would be delighted to meet with you to discuss these in person.

ShareAction’s 2015 report *Realigning Interests, Reducing Regulation: A vision for reforming UK workplace pensions*[6] notes that emerging best practice around the world includes schemes conducting surveys, focus groups, webinars and holding open meetings or AGMs to learn about the views of beneficiaries. The Dutch ABP scheme, for example, has a participants’ council and seats for member representatives on the board but also holds open meetings with beneficiaries to inform the scheme policies, including the RI policies.[7]

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[4] Waitzer, E., and Sarro, D. (2013), ‘Pension Fiduciaries and Public Responsibilities: Emerging Themes in the Law’, *Rotman International Journal of Pension Management*, Volume 6, Issue 2.
[5] Ibid, p.32.
[6] de Ste Croix, C. (June 2015), ShareAction, *Realigning Interests, Reducing Regulation: A vision for reforming UK workplace pensions*. Available online at: http://action.shareaction.org/page/-/ReducingRegulationReport.pdf. Last accessed 29 January 2016.
[7] Ibid, p.38.

Scheme management skills

Paragraph 38

We would suggest that automatic enrolment compliant pension schemes should be required to monitor and publish figures on the diversity of their governing boards.

Paragraph 47

We recommend including an obligation to make training for beneficiaries on governance boards compulsory. The training should be designed to give candidates the confidence and ability to ask challenging questions.

Paragraph 64

In the DC world, employers have less motivation to make sure schemes are working well than in DB where they bear risk. Therefore, we feel that senior management should be obliged to place a significant portion of any pension contribution from their employer in the same scheme as the rest of the workforce to align interests and provide motivation for senior management to scrutinise the scheme.

Value For Members

Paragraph 96

We think it would be helpful to add that assessing value for money involves considering how long-term sustainability or future risks are being addressed. For example, a low-cost scheme which failed to address longer-term financially material ESG factors would represent very bad value for money for members if the risks materialise and their pension pot is reduced.

Investment Governance

Paragraphs 101 and 109

We welcome the confirmation that the Pensions Regulator expects trustee boards to “take account of risks affecting the long-term financial sustainability of the investments” when setting investment strategies (Paragraph 101). Similarly, we are pleased to see the expectation for trustee boards to review their investment strategies to consider the long-term investment market conditions (Paragraph 109). This is a very positive development, especially in light of the 2012 Kay Review[8] identifying a problem of "short-termism" in UK capital markets, where investment managers invest on the basis of short-term movements in share price as opposed to the fundamental value of the company. In particular, Professor Kay noted that some pension fund trustees prioritised short-term financial returns over financially material factors which might impact on the long-term performance of investments, such as climate change.

[8] Kay, J. (July 2012), *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report*. Available online at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf. Last accessed 29 January 2016.

However, we would recommend further clarification, whether here or in the guidance, to ensure that lay trustees fully understand the meaning and implications of "long-term financial sustainability". By way of example, this clarification may be something like "such risks may include environmental, social or governance (ESG) factors. For example, the risks involved around climate change".

As discussed above, including a reference to the Law Commission's guidance, "Is it always about the money?", in the Code (or the guidance) would help to clarify for trustees the nature of their duties in respect of long-termism. The importance of this is demonstrated by the responses to the DWP's recent consultation on amending the Investment Regulations. 45 of 47 consultation responses called for changes to be made to the Investment Regulations, citing a need for trustees' fiduciary duties to be clarified.

Paragraph 104

We are very pleased that the Pensions Regulator is emphasising the importance of effective member engagement. We particularly welcome the confirmation that the Pensions Regulator expects trustee boards to ensure members have access to enough information to ensure they can make informed decisions about their investment choices. In a debate in the last Parliament, Lord Bourne of Aberystwyth noted that improved transparency (on wider issues than just costs) is a "vital" part of reforming pensions.[9]

It is essential that people should have access to clear, comprehensible information about how their money is invested, particularly when investing in DC schemes in which they bear all the investment risk. Giving such access enables and encourages people to take greater personal responsibility for their finances. Unfortunately, a lack of transparency is one factor which has contributed to market failings within the pensions sector, as acknowledged by the Office of Fair Trading's 2013 review of the DC workplace pensions market, which found that the buy-side was "one of the weakest" it had analysed in recent years.[10]

However, we feel that it would be helpful to insert a cross reference to paragraph 139 in the section entitled 'Communicating with members' in the draft Code, which states that the Pensions Regulator expects "trustee boards to ensure that all communications sent to members are accurate, clear, relevant and provided in clear English".

ShareAction undertakes regular surveys of the pensions sector and looks at the information made available to members. For example, in 2013/14 we surveyed the UK's largest occupational pension funds[11] and we are in the process of surveying the largest automatic enrolment providers and master-trusts. We also regularly create "email tools" enabling savers to email their pension funds directly to request information on various issues. Through these practical exercises, we have gained insight into how funds share information.

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[9] HL Deb 7 Jan 2015, vol 758, col 431. Available online at: http://www.publications.parliament.uk/pa/ld201415/ldhansrd/text/150107-0003.htm. Last accessed 29 January 2016.

[10] OFT (September 2013, revised February 2014), *Defined contribution workplace pension market study*. Available online at: http://webarchive.nationalarchives.gov.uk/20140402142426/http:/www.oft.gov.uk/OFTwork/markets-work/pensions/. Last accessed 29 January 2016.

[11] Toy, L. and Livesey, B. (2014), ShareAction, *Entrusted with our Future: A Survey of the Responsible Investment Performance of UK Pension Funds* (2014). Available online at: http://www.shareaction.org/sites/default/files/uploaded_files/investorresources/Entrusted_with_our_future_final.pdf. Last accessed 29 January 2016.

The Investment Regulations require the disclosure by trustees or scheme managers of principles, policies or approaches to issues. However, in practice, this translates into funds publishing statements which are often very general, at times vague and "boilerplate". In our experience, when members approach funds to ask questions about how their money is used in practice, they are directed to these statements. A typical example taken from the SIP of a large fund[12] is:

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.

It is difficult to see how a responsible individual could use this information to make informed decisions and to ask meaningful questions of a scheme. The issue that needs to be addressed is not whether funds disclose this information, but whether it is disclosed in a way which is meaningful to members. In our experience, this is not generally the case.

In our most recent review of the largest UK occupational funds[13], we found the following in relation to disclosure of equity holdings and the actual exercise of voting rights:

- 38% made no disclosure of their equity or other holdings.
- 25% only disclosed 5 to 10 of their largest equity holdings (a very small proportion of their portfolios), whilst 29% disclosed 100 or more equity holdings.
- 42% disclosed no information about how their shares were voted at company AGMs, with 21% providing only basic summary statistics.

Furthermore, the holding and voting of shares is only a small element of the potential influence pension funds have over investments in their portfolios. Far more important is the wider stewardship of investments, which includes engagement with managers of investee companies or entities in relation to (among other matters) corporate governance and corporate actions. Practice on disclosure of stewardship activities is poor, with just under half of the largest funds disclosing detailed stewardship and engagement reports. Amongst smaller funds, very little meaningful information is available. This is despite the fact that stewardship was recognised as important by the Law Commission, which stated 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*" (para. 5.98 of the Law Commission's 2014 review).

We would be delighted to attend further meetings to discuss this important series of consultations. We are grateful for having had the opportunity to speak with you at the meetings we have attended to date.

[12] GlaxoSmithKline, *Statement of Investment Principles*. Available online at: http://www.gsk.com/media/280781/pension-scheme-sip.pdf. Last accessed 29 January 2016.
[13] Ibid.

Yours sincerely,

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