ShareAction
the movement for Responsible Investment

Ground Floor, 16 Crucifix Lane
London SE1 3JW | 020 7403 7800

LGPS Reform
Department for Communities and Local Government
2/SE Quarter, Fry Building
2 Marsham Street
London
SW1P 4DF

By email to: LGPSReform@communities.gsi.gov.uk

19th February 2016

Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009

Dear Sirs,

We would like to respond to the above consultation paper relating to the Local Government Pension Scheme. 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.

Environmental, social and governance (ESG) factors

We are pleased to note that the draft replacement regulations include provision for administering authorities to publish their policies on the extent to which environmental, social and corporate governance factors are taken into account in the selection, retention and realisation of investments.

It is welcome to see confirmation in this consultation paper that the Law Commission's findings on fiduciary duty are applicable to the LGPS[1] and, therefore, that:

---

[1] Department for Communities and Local Government (2015). *Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009*, pp 14-15. Available from: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/479642/Consultation_on_investment_reform.pdf [accessed 19 February 2016].

- schemes should consider any factors financially material to the performance of their investments, including social, environmental and corporate governance factors, and over the long-term, dependent on the time horizon over which their liabilities arise;
- schemes may take non-financial considerations into account provided that doing so would not involve significant risk of financial detriment to the scheme and where they have good reason to think that scheme members would support their decision.[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, the Law Commission's subsequent review of the law in this area and the Government's consultation on amending the Occupational Pension Schemes (Investment) Regulations 2005. We also 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.

During the course of this work, we have continually identified misinterpretation and misapplication of trustees' fiduciary duties as a 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* (2011)[3] and *The Enlightened Shareholder* (2012)[4].

We therefore applaud the Government's recognition of the Law Commission's findings in the LGPS Investment Criteria and Guidance.

However, in order to ensure that this important clarification is fully made in the draft replacement regulations, we would strongly recommend making the following amendments:

- Amending **regulation 7(2)(c)** to read: '*the authority's approach to risk, which may include social, environmental or corporate governance considerations, including the way in which risks are to be measured or managed*'.

- Amending **regulation 7(2)(e)** to read: '*the authority's policy on how the following factors are taken into account in the selection, non-selection, retention and realisation of investments:*

  (i) the financial implications of social, environmental or corporate governance factors; and

  (ii) non-financial factors.'

---

2 Department for Communities and Local Government (2015*). Local Government Pension Scheme: Investment Reform Criteria and Guidance*, para 3.38. Available from: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/479925/criteria_and_guidance_for_invetment_reform.pdf [accessed 19 February 2016].

3 Berry, C. (2011). *Protecting our Best Interests: Rediscovering Fiduciary Obligation*, FairPensions. Available from: http://www.shareaction.org/sites/default/files/uploaded_files/fidduty/FPProtectingOurBestInterests.pdf [accessed 19 February 2016].

4 FairPensions (2011). *The Enlightened Shareholder: Clarifying investors' fiduciary duties*. Available from: http://www.shareaction.org/sites/default/files/uploaded_files/policy/EnlightenedFiduciaryReport.pdf [accessed 19 February 2016].

Financial and non-financial factors

We are concerned by the Government's proposal to issue guidance to administering authorities stating that non-financial considerations should not result in policies which pursue municipal boycotts, divestments and sanctions against foreign nations and the UK defence industry, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government.

We are also concerned that the Government intends to require administering authorities to explain in their investment strategy proposals how infrastructure will feature in their investment strategies, given the proposed powers of intervention which would appear to allow the Secretary of State to direct an authority's investment strategy.

It is widely accepted, as stated by the Government in this consultation paper[5] and Nigel Giffin QC in his 2014 opinion[6] on this issue, that an administering authority owes fiduciary duties to the members of its pension scheme. The LGPS is not trust-based and an administering authority is not, therefore, a *trustee* of its pension scheme. However, Mr Giffin comments that fiduciary duties are commonly held to exist in a situation where one person administers the property or financial affairs of another,[7] and this is clearly the relationship between an administering authority and the beneficiaries of its pension scheme.

Nigel Giffin QC expresses the following views in his 2014 opinion:

- In managing an LGPS fund, the administering authority has both fiduciary duties and public law duties. In practice, these are likely to come to much the same thing.
- The administering authority's power of investment must be exercised for investment purposes, and not for any wider purposes. Investment decisions must therefore be directed towards achieving a wide variety of suitable investments, and to what is best for the financial position of the fund (balancing risk and return in the normal way).

The Government recognises in this consultation paper that administering authorities should act in the interests of beneficiaries of their pension schemes. In the section entitled 'Response to the Law Commission's Review of Fiduciary Duty' in this consultation paper, the Government refers to the circular issued by the then Department of the Environment in 1983 (No 24), where the Secretary of State took the view that administering authorities should pay attention to the principle in *Roberts v Hopwood* [1925] A.C. 578:

"A body charged with the administration for definite purposes of funds contributed in whole or part by persons other than members of that body owes, in my view, a duty to those latter persons to conduct that administration in a fairly business-like manner with reasonable care, skill and caution, and with a due and alert regard to the interest of those contributors who are not members of the body. Towards these latter persons, the body stands somewhat in the position of trustees or managers of the property of others."

On this basis, we fully agree with the Government's position that an administering authority should act in the best interests of the members of its pension scheme. In line with the Law

---

5 Department for Communities and Local Government (2015). *Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009*, p14. Available from: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/479642/Consultation_on_investment_reform.pdf [accessed 19 February 2016].

6 Giffin, N. (2014). *Duties of Administering Authorities under the Local Government Pension Scheme*, pp2-3. Available from: http://www.lgpsboard.org/images/PDF/Publications/QCOpinionApril2014 [accessed 19 February 2016].

7 *White v Jones* [1995] 2 AC 207.

Commission's 2014 review, this means that administering authorities may (and, indeed, should) take account of any financial factor which is relevant to the performance of an investment, including ESG factors. ESG factors are increasingly recognised by investors to be financial risks. By way of example, the 2015 report from Mercer modelling the potential impact of climate change on investments found investors cannot ignore the implications for investment returns.[8] This is recognised in the *Local Government Pension Scheme: Investment Reform Criteria and Guidance*, which underlines the importance of schemes considering any factors financially material to the performance of their investments, including ESG factors, and over the long-term, dependent on the time horizon over which their liabilities arise.[9]

In relation to non-financial factors, the Law Commission was clear that trustees should also take account of these factors if two tests are met:

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

The Government clearly does not dispute that this two-part test is applicable to the LGPS in the same way that it is applicable to other occupational pension schemes. However, if this were to be disputed, we note that the effect would be to create two classes of pension schemes, with public pension scheme members being entitled to fewer rights than private pension scheme members.

Looking first at the financial factors to be considered by trustees, we note that the Secretary of State has said 'Divisive policies… harm the economic security of families by pushing up council tax"[10]. However, legislating to compel trustees to make investment decisions that they consider inadvisable is not in the interests of taxpayers. Blanket barring of divestment fetters the discretion of administering authorities to exit investments that they consider, under their acknowledged duty to act in the best interests of scheme members, to be financially risky.

For example, it is possible that this proposal may prevent councils from divesting from companies operating in Israel's West Bank settlements, despite the fact that the Foreign Office (FCO) currently advises private sector businesses against trading with or investing in such companies.[11] The FCO guidance was defended in December 2015 by the Secretary of State for International Development, Justine Greening. When Ms Greening was asked by the shadow transport minister Richard Burden whether she agreed it was "perfectly reasonable for both public and private institutions to pay due regard to that advice when they make their own investment and procurement decisions", Ms Greening said: "They should do that; that is good Foreign Office advice."[12]

---

8 Mercer LLC (2015). *Investing in a Time of Climate Change*. Available from: http://www.mercer.com/insights/focus/invest-in-climate-change-study-2015/executive-summary.html [accessed 19 February 2016].

9 Department for Communities and Local Government (2015*). Local Government Pension Scheme: Investment Reform Criteria and Guidance*, para 3.38. Available from: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/479925/criteria_and_guidance_for_invetment_reform.pdf [accessed 19 February 2016].

10 Department for Communities and Local Government (2015*). Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009*, p18. Available from: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/479642/Consultation_on_investment_reform.pdf [accessed 19 February 2016].

11 Foreign & Commonwealth Office (2015). *Overseas Business Risk – Israel*. Available from: https://www.gov.uk/government/publications/overseas-business-risk-israel/overseas-business-risk-israel [accessed 19 February 2016].

12 Macintyre, D. (2015). *Government accused of launching 'attack on local democracy' with new council investment rule*, the Independent. Available from: http://www.independent.co.uk/news/uk/politics/government-accused-of-launching-attack-on-local-democracy-with-new-council-investment-rule-a6786916.html [accessed 19 February 2016].

Furthermore, the adverse consequences of barring administering authorities from making divestment decisions may be difficult to foresee. The importance of environmental considerations for institutional investors was recently highlighted by the 2015 diesel emissions scandal. We have heard a number of asset managers report that they were not invested in the company because of its poor governance, a decision that now looks very wise. Under the new proposals, if a similar company had been based in Israel, administering authorities might have been prevented from making the decisions necessary to safeguard the investments of their pension schemes.

It must be emphasised that the nature of this particular issue is irrelevant: what matters is the principle that administering authorities need the freedom to make investment decisions in the best interests of their beneficiaries. Scheme employers will be liable to pay for poor investment decisions through increased contributions. In the case of local authority employers, this is likely to result in increased council tax payments. Furthermore, the long-term nature of pension investments would not be well served if they were tied to governmental foreign policies which are, by their very nature, short term. It is also worth noting that a future government may have different priorities for foreign policy to those held by the current Government.

Steering investments towards particular projects, whether those are favoured by central or local government, could be equally detrimental to the performance of LGPS investments. As CIPFA chief executive Rob Whiteman commented, "The funds must not become the investor of last resort, for example, for politically desirable infrastructure schemes that the markets do not see as investment grade proposals."[13] Again, a future government may have different priorities to the current Government and, once a power of intervention is granted, there is no way of predicting how it might be used in future.

With regards to non-financial factors, we agree that, in line with the Law Commission's guidance, an administering authority should not impose town hall policy on its members. The administering authority should **not** take the personal or political views of the local authority or local councillors into account when considering non-financial factors in investment decisions. However, in any attempt to make this clarification, it is vital that the Law Commission's two-part test is not undermined. If (a) members feel that a particular ethical issue is important; and (b) the administering authority considers that incorporating this issue into its investment decisions would not involve a risk of significant financial detriment to the fund, the authority may take that ethical issue into account. It is important not to undermine the Law Commission's findings and prevent divestment from a range of issues which are not financially material but are significant to members. Once the meaning and implications of the Law Commission's guidance are diluted, it is difficult to predict what ripple effects this may have. For example, there may be an adverse impact on the ability of local government pension schemes to make social investments, which members often support on the basis that they have a positive impact on the local area.

It is essential that an LGPS administering authority should be permitted the freedom to make all and any investment decisions that it perceives to be in the best interests of the beneficiaries of its pension schemes, by reference to the series of tests set out by the Law Commission. It is not appropriate for either the Government or local councils to allow political considerations to distort this critical decision-making process. It may, of course, be helpful to remind local councils of their duties in this regard.

---

[13] Russell, V. (2015). *CIPFA warns LGPS must not become "infrastructure investor of last resort"*, PublicFinance. Available from: http://www.publicfinance.co.uk/news/2015/11/cipfa-warns-lgps-must-not-become-%E2%80%9Cinfrastructure-investor-last-resort%E2%80%9D [accessed 19 February 2016].

Proposed asset pools

The Investment Reform Criteria and Guidance states that the proposed governance structures for the pools should ensure that investment implementation decisions are made with a long-term view. Stewardship and responsible investment activity should be at the heart of pension schemes' strategies for building the long-term value of investments. It will be important to issue clear guidance on responsibility for stewardship under the proposed pooling structure. This could, in part, be achieved by ensuring the proposed governance structures for the pools sign up to the Stewardship Code, the UN Principles for Responsible Investment and similar initiatives.

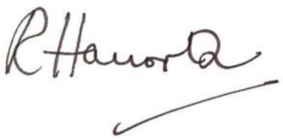
We are concerned that there are currently no proposals to include scheme members in the governance structures for the pools. A central finding of the Kay Review[14] is that incentives are often misaligned throughout the heavily intermediated equity investment chain. The inclusion of saver-elected representatives in governance structures is a key means of ensuring there is an alignment of interests with the wider scheme membership. Our 2015 report, *Reducing Regulation, Realigning Incentives,*[15] examines the important role of member-nominated trustees in more detail.

Conclusion

Given the complex issues raised by the proposals in this consultation paper, we would strongly recommend setting up an expert working group, including members of local government, pensions and investment bodies, to assist with drafting the new guidance. We would be delighted to be invited to contribute to a working group on this subject.

We would be pleased to attend a meeting with Ministers or officials to discuss our comments in more detail.

Yours sincerely,



Rachel Haworth, Policy Officer

[14] J Kay (2012). *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report*. Available from: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf [accessed 19 February 2016].

[15] de Ste Croix, C. (June 2015), ShareAction, Realigning Interests, Reducing Regulation: A vision for reforming UK workplace pensions. Available from: http://action.shareaction.org/page/-/ReducingRegulationReport.pdf [accessed 19 February 2016].