What has happened?

A new report published by the Law Commission has recommended regulatory change to clarify the law for investors and remove barriers to long-term, responsible investment in the UK. The report repeats proposals which the Government failed to implement during the last Parliament, specifically that the law should be clarified to confirm that pension schemes should report on their approach to environmental, social and governance (ESG) factors, scheme members' wider concerns and stewardship. The report also extends these proposals to FCA-regulated contract-based schemes.

The authors of this brief strongly support the Law Commission's report and are calling for the full implementation of its recommendations.

Summary

The Law Commission has published a report on the extent to which pension funds can or should consider the social impact of their investments. Social impact investing looks at social return as well as financial return, for example investment in social housing projects or green infrastructure. The Law Commission set out *recommendations* for legal reform which the Government should implement to reduce the impact of any current barriers and *options for reform* which other bodies might consider. This briefing focusses on the former.

The recommendations for legal reform build on the Law Commission's 2014 report into the fiduciary duties of investment intermediaries, which focussed on pension trustees. This new report repeats the Law Commission's call for the law to be clarified. These changes to the law are essential because the disclosure rules that pension fund trustees follow are inconsistent with legal guidance and guidance from the Pensions Regulator – leading to confusion. The report recommends that:

- Pension scheme trustees of all types should publicly state their policies relating to integration of ESG factors during the investment process, considering and responding to scheme members' ethical concerns and to state their policy (if any) on stewardship.
- COBS 19.5 should be amended to require Independent Governance Committees to report on the firms' policies relating to integration of ESG factors during the investment process, considering and responding to scheme members' ethical concerns and to state their policy (if any) on stewardship.
- The FCA should issue guidance for contract-based schemes on these issues.

The Law Commissioner responsible for the 2014 review expressed subsequent regret that the Investment Regulations were not updated, calling it a "missed opportunity"[1] which has left us with "outdated terminology and continued confusion".[2]

[1] https://shareaction.org/wp-content/uploads/2016/09/ClimateInvestmentDuties-InvestorReport.pdf, p13
[2] Ibid, p16

Why is clarification needed?

Confusion about the law is a barrier to long-termism

- In 2014, the Law Commission found that the current formulation of pension trustees' duties is "complex, difficult to find and not well known" and this "may lead trustees to be overly narrow in their approach to investment factors and to their beneficiaries' concerns".[3]
- In 2016, the Institute and Faculty of Actuaries stated that "pension scheme trustees generally consider **short-term financial** returns and risks to be their predominant concern in making investment decisions. In addition, **the legal provisions allowing trustees to consider longer-term and other factors are not well understood by trustees**, or often by investment advisers"[4] (emphasis added).
- Trustees structure their investment decision making around the Statement of Investment Principles (SIP). Although the Law Commission's recommendations may appear small and technical, they will impact the SIP and will therefore help trustees' decision making in respect of management of long-term risks.
- Stewardship, in particular, is concerned with creating long-term value in companies. The suggested changes in respect of a stewardship policy for schemes would focus minds on the need to undertake stewardship.

There is inconsistent regulation between scheme types, which is unfair to pension savers

- DCLG implemented the Law Commission's original recommendations for local government schemes. Local government funds are starting to develop these policies.
- Guidance from The Pensions Regulator (for trust-based schemes) reflects the Law Commission's 2014 findings, but this is confusing when read alongside the (unchanged) legal regulations, which do not reflect the findings.
- There is no FCA guidance or regulation for contract-based schemes on this issue.

Leaders in industry would welcome clarification

See the section below on the response from leaders in the investment industry.

Post-Brexit, the UK could gain from being a leader in the field of sustainable finance. Other jurisdictions, such as Germany[5] and Ireland, are positioning themselves in this respect. The issue of fiduciary duty is a key discussion in the EU at the moment. The UK must not be left behind.

What does the report say?

The Law Commission builds on its 2014 report into the fiduciary duties of pension trustees

In its 2014 report, the Law Commission stated that trustees *should* take into account all financially material factors, including those arising from ESG factors. These are not the same as "ethical" or non-financial factors because they can have a material impact on the performance of an investment.

[3] https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/03/lc350_fiduciary_duties.pdf (para 7.4)
[4] http://www.lawcom.gov.uk/wp-content/uploads/2016/11/pension_funds_call_for_evidence_responses.pdf
[5] See, for example, the Frankfurt Declaration of May 2017 http://deutsche-boerse.com/blob/3031308/6dbe47815720a97c638b9f2906922e0b/data/Frankfurt_Declaration-1.pdf

Pension trustees are also able to consider non-financial factors, in certain circumstances. These might include decisions aimed at improving members' quality of life, or divesting from a company to show moral disapproval. The law permits trustees to make investment decisions based on non-financial factors provided that:

(1) They have good reason to think that scheme members share the concern amongst themselves; and
(2) There is no risk of significant financial detriment to the fund.

The Law Commission recommended that the Occupational Pension Scheme (Investment) Regulations 2005 ("Investment Regulations") be amended to better reflect the difference between financial and non-financial factors. The existing language – which refers to social, ethical and environmental (SEE) factors – was found to have added unnecessary confusion for trustees over which factors should be considered when making investment decisions. The conflation between social and environmental factors, which may be financially material, and ethical factors, which are non-financial can lead to both a failure to consider long-term risks and opportunities and the concerns of beneficiaries.

Despite this, and even with 43 out of 45 respondents to its 2016 consultation calling for changes to be made, the Government chose not to amend the Investment Regulations. The Law Commission's new report calls for three key legal changes which are in-line with its 2014 recommendations.

1. Trustees should be required to state their policies relating to ESG, ethical investment and stewardship

Trustees structure their investment decision making around the Statement of Investment Principles (SIP) which must be reviewed every three years. The Law Commission reaffirms its assertion that the rules governing how SIPs are prepared are confusing, in particular the "SEE" clause (the reference to social and environmental factors alongside ethical ones).

It also notes that despite this change appearing to be small and technical in nature, the separation of financial and non-financial factors in the SIP will help structure their decision making to better manage long-term risk and to better respond to beneficiaries' ethical concerns.

The Law Commission therefore repeats its recommendation that the Investment Regulations are amended to require trustees to state in the SIP their policies in relation to evaluating long-term risks, including from ESG, considering and responding to members' ethical concerns and to require the trustees to report on their policy (if any) on stewardship.

2. IGCs should be required to report on the firm's policies relating to ESG, ethical investment and stewardship

Trust-based and contract-based pension schemes perform the same function and the Law Commission argues that the law should seek to achieve similar outcomes. Equally, both TPR and the FCA which regulate these schemes have stated that they have similar expectations for scheme quality and member outcomes.

The Law Commission therefore argues for equivalent requirements on trust and contract based pension schemes (usually administered by an insurance firm). It states that the duty on IGCs to report annually has the effect of structuring the questions they ask the firm which runs the pension scheme. Asking questions about financial and non-financial factors and stewardship will help focus the mind of the firm to consider these issues and so indirectly influences the firm's investment strategies.

The Law Commission therefore recommends a change to COBS rule 19.5 to require IGCs to report on the firm's policies in relation to evaluating long-term risks, including from ESG, considering and responding to members' ethical concerns and to require the IGC to report on the firm's policy (if any) on stewardship.

3. The FCA should issue guidance for firms on financially material and non-financial factors

The Law Commission's 2014 report was focussed on trustees and is therefore not applicable to contract-based pension schemes. These schemes are regulated by the FCA so TPR guidance does not apply to them. In a policy statement issued during the introduction of IGCs the FCA states:

> 'IGC members should not assume that they know what scheme members need and want. In this context, we would emphasise the importance of assessing members' views on ESG factors and on the availability and use in the default of ethical and long-term social investments'.

However, the Law Commission note that no guidance has been issued by the FCA to provide detailed direction for contract-based schemes. Given this is the case, the Law Commission recommends that the FCA issue guidance for contract-based scheme providers on financial and non-financial factors to follow the guidance already published by TPR in its Guide to Investment Governance.

What next?

The authors of this brief strongly support the Law Commission's recommendations which will remove a key obstacle to long-term, responsible investment**. We are therefore calling on the Government to clarify the law via the recommended changes to the Investment Regulations and for the FCA to introduce changes to COBS 19.5 and publish guidance on financial and non-financial factors.**

We call on the Government to issue a consultation on the Law Commission's recommendations, including draft regulations / proposed changes to the law so that respondents can comment.

In addition, the response from all parts of the responsible investment sector has been overwhelmingly positive and in favour of the Law Commission's recommendations.

What has been the sector response?

Jessica Ground, Global Head of Stewardship, Schroders: *"At Schroders we believe that sustainable investing creates real long-term value for our clients; an area which is equally important for DC members regardless of the type of DC scheme they are in. Therefore we welcome the Law Commission's recommendation that IGCs for contract based DC schemes be required to report on their firm's approach to ESG, ethical investing and stewardship in the same way that trust based DC schemes already do."*

Luke Hildyard, Policy Lead, Stewardship and Corporate Governance, PLSA: *"We support consistent standards for disclosure of responsible investment practices, for all types of pension fund. Demonstrating how members' ethical concerns are considered in investment decisions leads to better pension provision by building the trust and confidence of members."*

Will Oulton, Global Head, Responsible Investment, First State Investments: *"First State Investments believe that the way investment performance is measured needs to evolve if it is to reflect the fact that the allocation of capital and use of ownership rights have both real world and real investment impacts. We therefore fully support the Law Commission's recommendations that contract based pension schemes publicly report on their approach to stewardship and how they address ESG and sustainability issues and would urge the FCA to publish guidance to enable and encourage such schemes do this."*

Diandra Soobiah, Head of Responsible Investment, NEST: "*At NEST we welcome the Law Commission's clarification that there are no legal or regulatory barriers to social investment by pension funds. The clarification stands to bring comfort to trustees who wish to consider investments that support social goals to generate sustainable returns for their members.*"

Relevant links and material

- The Law Commissions 2017 report on *Pension Funds and Social Investment* is available here.
- The Law Commission's 2014 report on *Fiduciary Duties of Investment Intermediaries* is available here.
- DWP's response to the 2015 consultation on changes to the Investment Regulations outlining reasons it would not amend the regulations is available here.
- TPR has issued investment guidance for trustees of defined-benefit and defined-contribution pension schemes.

Contact

Fergus Moffatt, Head of Public Policy, UKSIF
fergus.moffatt@uksif.org 020 7749 9951