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Department for Work and Pensions
Strategy Policy and Analysis Group
Private Pensions and Arm's Length Bodies Directorate
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16 July 2018

Dear Sirs

Consultation on clarifying and strengthening trustees' investment duties: The Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations

We are responding to the above consultation on behalf of the Investment Sub-Committee of the Association of Pension Lawyers of the United Kingdom ("**APL**").

The APL is a not-for-profit organisation whose members comprise over 1,100 UK lawyers, including most of the leading practitioners in the field, who specialise in providing legal advice on pensions to sponsors and trustees of pension funds and others, including the largest pension funds in the UK. Its purposes include promoting awareness of the role of law in the provision of pensions and to make representations to other organisations and governments on matters of interest to APL members.

General Comments

We wish to thank you for inviting Hugh Gittins and Stuart O'Brien to discuss the consultation with you in person at a meeting on 4 July 2018. We found this extremely helpful to exchange initial views on the consultation and the draft Regulations face-to-face. As discussed at that meeting, we are broadly supportive of the proposed regulatory changes set out in the consultation. This letter sets out our further responses to the specific questions raised in the consultation and our comments on the proposed wording of the regulatory changes.

In general, it is not the role of the APL to comment on matters of policy. However, we do provide some commentary on policy points that we consider may have material impacts on the pension schemes which our members advise.

RESPONSES TO THE CONSULTATION QUESTIONS

***Question 1**: We propose that the draft Regulations come into force approximately one year after laying, with the exception of the implementation report, which would come into force approximately 2 years after laying.*

a) Do you agree with our proposals?

We agree that this is an appropriate timeframe. We also agree that it is more appropriate, as the consultation proposes, to provide for a uniform date when the regulations would apply to all schemes rather than a phased approach for example applying at a scheme's next Statement of Investment Principles (SIP) review date. Different pension schemes tend to update their SIPs with varying frequency so that, whilst some schemes may only review and update their SIP in line with the 3 year statutory limit, those which include more detail on the specific investments of the scheme may update their SIPs far more frequently.

b) Do you agree that the draft Regulations meet the policy intent?

We agree that the draft Regulations meet the above policy intent.

***Question 2**: We propose to require all trustees of all schemes, which are obliged to produce a SIP, to state their policy in relation to financially material considerations, including, but not limited to, those resulting from environmental, social and governance considerations, including climate change.*

a) Do you agree with the policy proposal?

We agree with the Law Commission's findings that the current language of Regulation 2(3)(b)(vi) of the Occupational Pension Schemes (Investment) Regulations (the "Investment Regulations" has been a source of confusion for pension trustees. The proposed replacement of the current wording in the regulation with a reference to "environmental, social and governance considerations" (ESG) will be helpful to displace this confusion and in particular the conflation in the current wording of the regulations of "environmental and social" considerations (which may frequently be of material financial relevance to a pension scheme's investments) with "ethical" considerations (which are more likely to be a non-financial factor).

We do note that there remains some debate as to what matters might be categorised as ESG factors and agree with the Law Commission's findings that the label probably remains ill-defined. However, the use of "ESG" terminology is now in sufficiently common parlance that

on balance, we think it is the most appropriate wording to be used in Regulation 2(3)(b)(vi). It is also noteworthy that the ESG terminology is used without definition in IORP II.

As noted above, we do not generally comment on policy objectives. However, we do wish to express our broad support for the following two points apparent from the draft Regulations:

- Removal of the current "(if at all)" wording in Regulation 2(3)(b)(vi) of the Investment Regulations

  We agree with the Law Commission's findings that, where ESG considerations are financially material to a pension scheme's investments, they should be taken into account by the scheme's trustees. Whilst the current wording of the Investment Regulations did not change this legal position (and simply refers to what must be covered in a scheme's SIP), we consider that the current use of the wording "(if at all)" in the Investment Regulations may have previously given rise to an incorrect assumption among some trustees that environmental and social considerations are always "optional" factors for trustees to consider. As there is a growing consensus that ESG factors will be financially material for many pension schemes we think that deleting the "(if at all)" wording will be helpful to dispel this assumption. Again, we do not consider that doing so will change the legal position in terms of trustees' fiduciary duties of investment, which remain for each set of trustees to consider what factors are or are not financially material to the circumstances of their own scheme. We consider that the draft Regulations allow sufficient flexibility for this to continue, whilst making clear that ESG factors should specifically be considered within this framework. We consider that this is the right approach.

- Specific mention of "climate change"

  We consider that climate change falls sufficiently within understood concepts of ESG that it does not from a technical legal point of view need to be separately identified in the draft Regulations. However, we note the policy intent is to draw specific attention to climate change as a cross-cutting ESG factor to be considered in particular. We do not disagree with this.

b) Do the draft Regulations meet the policy intent?

We consider that the draft Regulations generally meet the policy intent and, as noted above, agree that Regulation 2(3)(b)(vi) of the Investment Regulations will be improved by making reference to "ESG" considerations (including climate change) rather than the current wording. However, we do have a number of concerns over the current drafting as follows:

(i) Defining ESG considerations within a broader heading of "financially material considerations"

Whilst we can see why the draft Regulations have been drafted this way to reflect the distinction drawn by the Law Commission between financial and non-financial factors and the possibility that "ESG" could in future become an outmoded term, we think that defining ESG considerations simply as a subset of a wider definition of "financially material considerations" may have a number of disadvantages and possible unintended consequences. As currently drafted, the amended Regulation 2(3)(b)(vi) of the Investment Regulations would require trustees to have a policy on all matters that might be financially material to the performance of the scheme's investments. This could be a very extensive list. Taken literally, we think there is a risk that some trustees may seek to comply with this by providing long generic lists of all matters that might affect a scheme's investments. This could significantly detract from two of the policy intentions expressed in the consultation of encouraging trustees to focus on financially material ESG and climate change risks and making SIPs less generic.

(ii) The use of the word "includes" within the definition of "financially material considerations"

The way the definition of "financially material considerations" is drafted, when read narrowly, suggests that ESG factors will always be financially material. In other words that anything that is an ESG factor, by definition, will be a subset of financially material considerations. We do not think that this is the policy intent as there will likely be some ESG factors that are not financially material within the circumstances of any given pension scheme. The current wording of the draft regulations does not cater for this possibility. We think that the intention is for ESG factors to be a non-exhaustive subset of considerations for trustees where financially material. This could be addressed by further refinement of the definition of "financially material considerations" so that it includes ESG (including climate change) only where financially material. However, we have proposed a simpler solution to the drafting below.

Drafting recommendation

Where the policy intent is to cause trustees to consider ESG and climate change matters we wonder whether it would be simpler to amend Regulation 2(3)(b)(vi) of the Investment Regulations to refer directly to ESG considerations. Some suggested wording for Regulation 2(3)(b)(vi) might accordingly be as follows:

> *"(vi) environmental social and governance considerations (including climate change) which the trustees determine to be financially material, including how*

those considerations are taken into account in the selection, retention and realisation of investments."

It seems to us that this approach would not only deal with the issues identified in paragraphs (i) and (ii) above, but would also have the following advantages:

- It would more directly mirror the wording under Article 30 of IORP II which requires that IORPs should prepare a statement of investment-policy principles containing, among other things, "how the investment policy takes environmental, social and governance factors into account."

- It more clearly allows trustees, having stated their policy on ESG more generally, to determine within the context of their own scheme which ESG factors are judged to be financially material. We think there is an important distinction to be drawn here between the trustees' legal fiduciary duty (which will always be to take financially material considerations into account) and the purpose of Regulation 2(3) of the Investment Regulations which is simply to specify certain matters that must be documented in a scheme's SIP.

Question 3*: When trustees prepare or revise a SIP, we propose that they should be required to prepare a statement, setting out how they will take account of scheme members' views.*

a) Do you agree with the policy proposal?

Whilst we are supportive of the need for trustees to engage appropriately with scheme beneficiaries and to be clear in their policies on ESG (including climate change), we can foresee significant practical issues with this element of the proposals under the consultation in relation to member views on non-financial matters. These are as follows:

- Encouraging of member surveys

  We are aware that many have read the consultation as an indication that the DWP wishes to encourage trustees to seek member views on non-financial matters. We do not believe that this is the case. Rather, we had read the consultation and the draft Regulations as providing a mechanism by which trustees who do take account of non-financial factors in their scheme's investment strategies to specify how and why this is done. This may be particularly relevant for affinity groups, as identified by the Law Commission. We consider, however, that the draft Regulations are not intended to impose any requirement on schemes generally to do this.

Notwithstanding that this is our reading of the draft Regulations and the consultation, we think that there is a significant risk of misinterpretation and false expectations being raised among pension scheme members. The requirement for a statement to be provided on the extent to which scheme members' views will be taken into account is likely, in our view, to give rise to expectations that they will be or even that they must be. This is likely to make it difficult for schemes which quite legitimately and in line with their fiduciary duties, do not and in many cases cannot take them into account. We consider that this will be the vast majority of occupational schemes and particularly defined benefit schemes. Put simply, the legal ability of trustees to take member's views on non-financial factors into account is likely to be extremely limited (on which see further below). Any requirement for a member views statement will suggest otherwise.

- Further confusion between ESG and ethical matters

  We think there is a real danger of trustees becoming side-tracked on member views on non-financial matters rather than focusing on ESG and climate change as material financial considerations. As noted above, we consider that the current regulations may have already caused trustees to conflate non-financial ethical issues with financially material ESG and climate change issues. We think a requirement for member statements on ethical matters may further muddy the waters. Trustee governance time is also limited for most schemes. We consider that experience may run contrary to the policy objectives if trustees divert time and attention on member ethical views at the expense of considering financially material ESG factors as part of their fiduciary duties.

- Limited legal and practical relevance of non-financial factors

  As mentioned above, the case law has held that the circumstances in which it is appropriate for trustees to take non-financial factors, including the ethical views of members, into account are very limited. The first case which considered the issue (*Cowan v Scargill*, in 1985), held that the circumstances in which it might be appropriate for trustees to take into account non-financial factors are "very rare", where "the only actual or potential beneficiaries of a trust are all adults with very strict views on moral and social matters" – conditions which in practice are simply not going to be met, except possibly in relation to schemes sponsored by an affinity group.

  The Law Commission in its 2014 report also refers to the 1996 case of *Harries v Church Commissioners*, as authority for the proposition that it may be appropriate for beneficiaries' views on ethical matters to be taken into account by trustees where there was "no risk of significant financial detriment" in doing so. However, the judge in that case emphasised the difference between a charity (which that case was about) and a pension fund. Although the Law Commission articulated this test as applicable to

pension schemes, there is no established case law directly approving such a test and, in any event, what may constitute a "significant" financial detriment remains unquantified and untested.

For these reasons the legal position, at best, is that Trustees should be extremely cautious about taking non-financial factors into account (such as member ethical views) in any circumstances other than as a "tie-breaker" between two financially equal choices. And, in practice it will be extremely difficult for most pension trustees to determine risks of financial detriment (and its significance) at these margins.

This supports the point we make above that specifically requiring pension schemes to state the extent to which members' views are taken into account elevates the significance of that issue to a higher level than it ought to have, given that the circumstances in which trustees will be able to take those views into account (at least in a defined benefit context) are so limited. We also consider that in practice, many concerns of members in relation to a pension scheme's investment (such as environmental and climate change concerns or social issues) will have financial attributes to them such that they can usually be considered as part of the trustees' ESG policy rather than as non-financial factors.

- Distinguishing between member views in defined benefit and defined contribution schemes.

  The concerns expressed above relate in the main to defined benefit schemes, where the purpose of a scheme's investment power will be to invest for the provision of a defined level of benefits, with risks generally underwritten by the scheme's sponsoring employer.

  We can see more sense in the relevance of member views in defined contribution schemes and for the purpose of ensuring that members are given a suitable range of funds appropriate to their needs. This may include offering member "self-select" funds with particular ethical or social impact attributes.

  On this basis, if there remains a strong policy intent for a statement setting out how member views are taken account of, we consider that this should be confined to defined contribution schemes only.

b) Do the draft Regulations meet the policy intent?

See our comments above.

***Question 4**. Do you agree with our proposal not to require trustees to state a policy in relation to social impact investment? If not, what change in legislation would you propose, and how would you address this risk of trustee confusion on this point?*

We agree with the proposal and that it is likely to cause confusion to make further changes in relation to social impact investment before trustees have adjusted to and fully familiarised themselves with ESG issues more generally as a financially material risk issue.

***Question 5**: We propose that trustees should be required to include their policy in relation to stewardship of the investments (including monitoring, engagement and voting) in the SIP.*

a) Do you agree with the policy proposal?

We agree that it is sensible to view stewardship more widely than simply the exercise of voting rights as per the current wording of Regulation 2(3)(c) of the Investment Regulations.

b) Do the draft Regulations meet the policy intent?

We consider that the draft Regulations broadly meet the policy intent. However, we were unsure whether the level of detail specified in the definitions of "relevant matters" and "relevant persons" was strictly necessary. A broader reference to "engagement activities" may in our view suffice to meet the policy intent.

***Question 6**: When trustees of relevant schemes produce their annual report, we propose that they should be required to:*

- prepare a statement setting out how they have implemented the policies in the SIP, and explaining and giving reasons for any change made to the SIP, and

- include this implementation statement and the latest statement outlining how trustees will take account of members' views in the annual report.

a) Do you agree with the policy proposal?

As stated above, the APL does not generally comment on matters of policy. However, we consider that this proposal may achieve the outcome of making the SIP more of a "live" rather than a "tick box" document and we can see that this may improve pension scheme governance generally.

b) Do the draft Regulations meet the policy intent?

Yes.

***Question 7**: We propose that trustees of relevant schemes should be required to publish the SIP, the implementation report and the statement setting out how they will take account of members' views online and inform members of this in the annual benefits statement.*

a) Do you agree with the policy proposal?

Again, the APL does not comment on matters of policy, but we can see the sense in this proposal.

b) Do the draft Regulations meet the policy intent?

Yes.

***Question 8**: Do you have any comments on the business burdens and benefits and wider non-monetised impacts we have estimated in the draft impact assessment?*

In light of the comments above about the (possibly incorrect) inference that trustees are likely to draw that they should be ascertaining members' views where they do not already know them, we consider that the business burdens identified in the draft impact assessment are understated. Schemes that decide to obtain members' views will have costs associated with both the initial gathering of information and the subsequent monitoring of members' views (e.g. through a web portal), and also with the decision making about how to take those views into account once they are known. Even in a large scheme any added governance entailed will be unwelcome.

We also consider that the impact may be felt disproportionately by smaller schemes.

***Question 9**: Do you have any other comments on our policy proposals, or on the draft Regulations which seek to achieve them?*

Although it goes beyond the remit of this consultation, we think it would be beneficial for the DWP to consider whether the SIP requirements might usefully be split for DB and DC schemes, since the factors relevant to each will differ.

We think it may also be beneficial to specifically allow for schemes with multiple sections (be that DB and DC, or segregated sections in an industry wide scheme or mastertrust) to operate different SIPs per section. This could make transparency with members more relevant and targeted.

***Question 10**: Do you agree that the revised statutory guidance clearly explains what is expected of trustees in meeting their duty to publish the SIP, implementation statement and statement of members' views?*

We broadly agree.

Please direct any reply to the APL in this matter to Stuart O'Brien at stuart.obrien@sackers.com or at the address set out above.

Yours faithfully

Stuart O'Brien

For and on behalf of the Association of Pension Lawyers