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Dear Sirs,

Pension trustees: clarifying and strengthening investment duties

This letter sets out Eversheds Sutherland's comments on the above consultation which was issued on 18 June 2018.

Introduction

We have one of the largest teams of pensions lawyers in the UK, with over 65 specialist pension lawyers. Our clients include employers, trustees of a number of the UK's largest public and private sector occupational pension schemes and some of the country's leading master trusts, insurance companies and pension providers.

Our response represents our own views on the consultation and not those of our individual clients (unless expressly stated otherwise). However, in forming our views we have taken account of our clients' interests and concerns as well as considering the potential impact of any changes on individuals, society and the wider pensions industry.

General comments on proposals and policy intent

Comments on specific questions raised in consultation paper

Taking each of the specific questions you raised in turn:

Q1. We propose that the draft Regulations come into force approximately 1 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?

IORP II must be implemented in UK law by 13 January 2019 and schemes are increasingly concerned about what additional obligations they may need to comply with in a relatively short time frame. We note that these proposals will in part comply with requirements in IOPR II (specifically in Articles 19(1)(b), 21(1), 25(2)(g), 30 and 41).

If it is the Government's intention that these provisions will bring the UK's legislation into compliance with the investment aspects of IORP II and no additional legislation will be needed to ensure compliance, it would be helpful if that could be clarified so schemes are not left wondering if there will be further and earlier obligations imposed on them.

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

We agree that the timing of the new SIP requirements and the implementation report should be staggered to ensure that the report is based on a SIP prepared under the new requirements.

Q2: We propose to require all trustees of 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

Not entirely.

It has not been our experience that there is significant confusion and misapprehension about trustees' duties in an investment context. In addition, to the extent that trustees do not actually decide on scheme investments themselves or (at least in smaller schemes) even investment strategy, but rely on investment consultants, such concerns would be better addressed not by imposing additional statutory duties on trustees but by educating the industry as a whole.

Where trustees do not take ESG type factors into account when investing scheme assets it may well be because they are appropriately focused on protected returns and maintaining appropriate levels of risk. Investments will often be in pooled funds which generate the level of returns at a level of risk the trustees have selected without regard to the underlying assets. In a trust law context this complies with their duties and nothing further is required. It may well be that the managers of these pooled vehicles take into account ESG type factors in making investments and trustees (or their investment consultant) may (or may not) consider these as part of their pooled vehicle selection.

The Government is clear that it does not intend to direct investment decisions but requiring trustees to take into account ever more prescriptive factors comes quite close to that, particularly when the consultation paper states that the range of situations where trustees can properly conclude that there is no need to consider ESG type factors is likely to be fairly limited. We do not believe that this is an accurate summation of the law. In addition, where trustees invest primarily through pooled vehicles or use a fiduciary manager, their ability to consider ESG factors is severely limited by the advice they receive.

Climate change may well be a material future risk but it is not appropriate to attempt to mitigate that risk by forcing institutional investors to spend time and money dealing with an issue which is more properly one which should be dealt with by legislation relating to investee companies.

Practically, as almost all trustee investment decisions are made on the basis of advice (and recommendations) from the trustees' investment consultant, the extent to which ESG factors can be considered is limited by the investments actually recommended by such consultants. Accordingly, if the policy intent is to drive investors towards investments that take more account of ESG factors, it may be better achieved by imposing obligations on the research departments of investment consultants to put a higher emphasis on these factors (to the extent they do not already do so).

For these reasons. we do not think that the proposed amendments will necessarily lead to a change in practice but simply to a change in the way the SIP is drafted and increased administrative costs for occupational pension schemes.

b) Do the draft Regulations meet the policy intent?

Not in our view. On the assumption that the main intent is to ensure that trustees better understand their duties in relation to the consideration of non-financial factors when investing scheme assets, we do not think that the draft regulations achieve this.

The proposed amendments will require trustees to state their policies in relation to financially material considerations and the extent to which they are taken into account in investing scheme assets. Financially material considerations are currently proposed to be defined as including, but not limited to, ESG considerations including climate change.

As ESG considerations are just an example of financially material considerations, the proposed wording does not provide any clarification for trustees in relation to what financial considerations are in principle. In addition, the proposed definition suggests that ESG factors and climate change will always be financially material whereas that is not the case. Often such considerations will have little or no impact on the projected risks and returns associated with a particular investment and do not need to be considered.

Q3. 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?

No. The Law Commission's report indicated that member views were relevant where trustees were deciding to make an investment that was not in the financial best interests of the scheme and would not therefore be generally in line with their fiduciary duties. However, the Law Commission concluded that where members shared a common concern, trustees could take that into account rather than being solely motivated by financial factors.

This does not mean that trustees should generally take such considerations into account. As a matter of trust law, they should not.

In a DB scheme, the investment risk is underwritten by the employer, not the members. Both case law and the Pensions Regulator support the notion that trustees should have some regard to the financial position of the employer when exercising their investment powers. However, the opinion of members has no relevance and to suggest that trustees should have to consider potentially competing employer and member views places an unnecessarily difficult obligation on them.

A requirement for DB schemes to canvass and set out member opinions suggests that such views should generally be of relevance to the trustees when, particularly in a DB context, they are not and should not be.

We acknowledge the fact that the consultation paper is clear that the trustees are not bound to take member views into account and even that their statement can say that they have not done so. However, where trustees do canvass such views, it may create a member expectation that they will influence trustee investment decisions and may give rise to member complaints where they do not. Although trustees will be able to deal with such complaints, in our view this would impose an additional administrative burden on trustees for no gain to members.

We accept that the position is different in a DC scheme where members bear the investment risk and where they will often have investment choices to make. Member views may have a greater role to play in the availability of investment options. Therefore, if this provision is retained, we would suggest that it is limited to DC schemes.

However, even in relation to DC schemes, we are not clear that the definition of non-financial matters is appropriate. Although case law and the Law Commission suggests that there are circumstances in which it might be appropriate to take into account ethical considerations, we are not clear the extent to which it would ever be appropriate to take into account issues such as the present and future quality of life of members or even to invite views on this as the trustees should be selecting investments in the interests of the membership as a whole, not in response to concerns about individual member's quality of life.

From a wider perspective, it is unclear what issue or risk actually needs to be addressed or remedied in this respect. In DC schemes, there are typically low levels of member

engagement on investment options, even where there are specific communications on such matters issued by trustees. In practice, the vast majority of DC members are invested in the relevant scheme's default fund. If and to the extent that members raise any questions or issues concerning the range of funds and/or the availability of "ethical" funds, this would be addressed by the trustees specifically.

Q4. Do you agree with our proposal not to require trustees to state a policy in relation to social impact investment?

Yes.

Q5. 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 this proposal?

Not entirely. In our view requiring small schemes to have a policy on stewardship again goes beyond trustees' investment duties and any meaningful policy will impose a disproportionate cost on them. Most small schemes simply require their managers or custodians to vote in relation to specific industry guidelines rather than expressing specific views on voting or stewardship.

Although the consultation paper acknowledges that schemes will be able to have "a policy of no policy", it unhelpfully goes on to say that trustees will generally wish to have one to comply with their fiduciary duties. We do not consider this is correct – if trustees are taking advice on risk and returns from investment advisers, that is enough to comply with their fiduciary duties. It is not correct to say that they will always need to take stewardship into account or even that they will always need to ensure that their fund managers have done so.

b) Do the draft Regulations meet the policy intent?

We would suggest deleting the words in brackets in proposed regulation 3(c)(ii) as we think that this requires a level of detail in stewardship policies that most schemes will struggle to comply with. If the level of detail is too great, more schemes will default to having no effective policy at all.

Q6. 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 include this implementation statement and the latest statement outlining how trustees will take account of members' view in the annual report.

a) Do you agree with the policy proposal?

We have no strong views about this but wonder about the extent to which members will find information about compliance with the SIP useful.

In particular, the SIP is required to contain information such as the balance between different kinds of investment and expected returns. In a DC scheme offering a wide range of investment options and where the member has had a choice where to invest, such statements will often provide a member with little useful information about how their own benefits are invested. Statements about the spread of investment options generally rather than the specific options a member is invested in may actually lead to confusion.

To the extent that trustees will be required to publish this information on line under the proposals discussed below, we are not sure why such information also needs to be available on request.

b) Do the draft Regulations meet the policy intent?

Yes.

Q7. 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?

Partially. We have been heavily involved in the project to produce a simplified annual benefit statement and are concerned that this will be the third additional piece of information that has needed to be included in the last year. It would be helpful if DWP could consider amalgamating this and the existing requirements into a simple statement saying that members can access additional information on costs and charges on line.

In addition, we do not support publishing the statement setting out how trustees will take members' views into account. As explained above we do not think that this is consistent with trust law requirements and will simply create an expectation that trustees will follow members' views. We cannot see any advantage to members in having this information.

b) Do the draft Regulations meet the policy intent?

Yes.

We have no further comments on how the SIP is functioning in general and the benefits and burdens of the proposed changes to the Investment and Disclosure Regulations.

If you have any queries in relation to any of the points raised in this letter, please contact Karen Mumgaard at karenmumgaard@eversheds-sutherland.com.

Yours faithfully,

Eversheds Sutherland (International) LLP