

Response to the Department for Work & Pensions Consultation on clarifying and strengthening trustees' investment duties from Philip Bennett

About the author: Philip Bennett retired as a partner at Slaughter and May at the end of December, 2017 after more than 30 years advising employers and pension funds on the UK legal and pensions tax related aspects of their pension schemes. He is a former chair of the Association of Pension Lawyers' Legislative and Parliamentary Sub-committee, a former chair of the International Pension and Employee Benefit Lawyers Association and a former member of Pensions Europe's Defined Contribution and Defined Benefit Working Parties. He has had extensive experience in advising clients on complying with UK pensions legislation and pensions tax related legislation that has come into force over the past 30 years (including the Pensions Act 1995 (the first major Act of Parliament regulating UK pension schemes), the Pensions Act 2004 (introducing mandatory scheme funding for defined benefit pension schemes and the "moral hazard" powers of the Pensions Regulator), the Pensions Act 2008 (auto enrolment) and the Finance Act 2004 (pension tax "simplification")). In particular, he has advised Trustees of large pension funds on the legal aspects of investing the pension fund asset (including drafting and reviewing Statements of Investment Principles and managing the associated legal risks for Trustees when investing).

A. Overview of this response

1. This response is structured as follows:
 - ◆ **Section A**, covers a number of general points which are relevant to the specific questions raised in the Department for Work & Pensions (the "DWP") June 2018 White Paper "Consulting on clarifying and strengthening trustees' investment duties" (the "**Consultation Paper**") and the associated draft Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2018 (the "**Draft Regulations**").
 - ◆ **Section B**, sets out the response to the 11 questions raised in the Consultation paper.
2. This response is made by the author in his personal capacity.
3. The author can be contacted by email at pfb@bennettfox.com, if the DWP wishes to discuss anything in this response.

B. General points relevant to the response to the questions in the Consultation Paper

1. **Overview of the current legal constraints on trustee investment decision taking by pension fund trustees**
 - 1.1 **Table 1** below summarises the main constraints, in the author's view, on investment decision taking by pension fund trustees.
 - 1.2 The summary is included for convenience and context in relation to the responses to the 11 questions on which the DWP is consulting in the Consultation Paper. It may also help to draw together, from a practical perspective, the interaction between the various constraints that apply in the real world when advising pension fund trustees.
 - 1.3 The author is in general agreement with the analysis of the legal position as set out in the 2 Law Commission Reports in this area:
 - ◆ The Fiduciary Duties of Investment Intermediaries of 30th June, 2014¹, and
 - ◆ Pension Funds and Social Investment of 22nd June, 2017².
 - 1.4 However, the author considers the Law Commission Report to be incorrect insofar as it permits even an insignificant level of financial detriment to be suffered when investing the pension fund's assets in order to take account of members' views.

¹ Report No. 350.

² Report No. 374.

- 1.5 The reasons for the author's conclusion are summarised in **4** below and are set out in more detail in **Annex A**.

Table 1

Constraints on pension fund trustee investment decision taking

Constraint	Legal authority for the restriction	Comment
1. Constraints imposed by the express terms of the pension fund's governing trust deed	<p>1.1 Trust law as modified by Section 34 and Section 35 of the Pensions Act 1995.</p> <p>1.2 Section 34 confers on trustees wide powers of investment subject to any constraints on those powers in the governing trust deed</p> <p>1.3 Section 35 crosses out any restriction on investment powers imposed which requires the consent of the employer.</p>	<p>1.1 If the sponsoring employer, when establishing the pension fund, wishes to prevent the trust assets being invested in certain types of investment, that can be written in to the trust deed.</p> <p>1.2 The option to restrict trustee investment powers by the use of appropriate wording in the pension fund trust deed is a useful risk management technique, particularly where the sponsoring employer would suffer material reputational damage if its pension fund were to invest in, for example, shares in particular companies.</p> <p>1.3 For example, if the sponsoring employer is a cancer research charity, then the pension fund trust deed of such a charity could usefully restrict the powers of the trustees to exclude investment in shares of tobacco companies.</p> <p>1.4 Similarly, in relation to a money purchase scheme (or the money purchase section of a defined benefit scheme), in the author's experience, it is relatively common for the Trust Deed of such a pension scheme to limit the investment powers of the trustee to investing in pooled investment vehicles³. The reason for this is that it then restricts the size of the "investable universe" which the Trustees and their advisers need to consider.</p> <p>1.5 In other words, if the sponsoring employer wishes the trustees to offer members, as one of the investment options for their retirement accounts in the pension scheme, an "ethical" investment option, then that can be covered by requiring the trustee to offer such an investment option under the terms of the trust deed.</p> <p>1.6 In other words, the use of appropriate restrictions on the investment powers of the trustee can very considerably simplify the extent of the legal advice which trustees may otherwise require and avoid a number of the difficulties that are referred to in Section 2 below (which is immediately after the end of this Table 1).</p>

³ E.g. unit trusts or unit linked life policies or open ended investment companies.

Constraint	Legal authority for the restriction	Comment
2. Constraints imposed by the Financial Services and Markets Act 2000 ("FSMA").	<p>2.1 Section 19 of FSMA says, in summary, that no person may carry on a regulated activity in the United Kingdom, unless that person is authorised or exempt (the "General Prohibition").</p> <p>2.2 The General Prohibition in Section 19, applies to the investment of pension fund assets which are investments for the purposes of the FSMA⁴</p> <p>2.3 The General Prohibition on managing the investment of the assets of a pension fund which are investments for the purposes of FSMA is contained in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, Article 37.</p> <p>2.4 Prima facie, a pension fund trustee might appear to escape from the Article 37 prohibition via Article 66(3).</p> <p>2.5 However, Article 4 of the Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order 2001 says that a pension fund trustee will be treated as requiring authorisation unless the trustee:</p> <p>(a) is not undertaking "day to day" investment management activity, or</p> <p>(b) falls within the exception for making specific investments with advice from an authorised person, in general, in a pooled investment vehicle.</p> <p>2.6 That exception is to be found in the Financial Services and Market Act 2000 (Carrying on Regulated Activities by Way of Business) Order, Article 4(6).</p>	<p>2.1 It is a criminal offence to contravene the general prohibition in Section 19 of FSMA.</p> <p>2.2 Guidance has been given by the Financial Conduct Authority as to what is meant by day to day investment management decisions in PERG 10.3, Q7-Q19 of the FCA Rule Book.</p> <p>2.3 PERG 10.3, Q8 contains some additional helpful exceptions relating to policy considerations such as investments in certain territories or markets in ethical or green areas.</p> <p>2.4 PERG 10.3, Q16 includes helpful guidance on the exercise of voting rights.</p>
<p>3. Constraints imposed by the statement of investment principles on the trustee (or the investment manager to whom discretion to manage the portfolio has been delegated):</p> <p><i>"[trustees] must exercise their powers of investment with the view to giving effect to the principles contained in the statement [of investment principles] under section 35 [of the Pensions Act 1995], so far as reasonably practicable"</i></p>	<p>Section 36(5) of the Pensions Act 1995.</p> <p>Note: The content requirements of the statement of investment principles are set out in Regulation 2 of the Occupational Pension Schemes (Investment) Regulations 2005.</p>	<p>3.1 If investments are made outside of the statement investment principles⁵, then the trustee or, as the case may be, investment manager is investing outside of its investment powers and committing a breach of statutory duty (with the associated consequence of being liable to have to reinstate the loss sustained by the pension fund – and see also Row 4 below).</p> <p>3.2 To manage legal risk to the trustee and the investment manager, the legal advice is generally going to be to write a statement of investment principles in high level, generic terms so that the risk of liability for breach is managed down.</p>

⁴ The principal assets which are not investments for FSMA purposes are direct investment in land or buildings.

⁵ Where it is reasonably practicable (an objective test) to invest within the constraints of the statement of investment principles.

Constraint	Legal authority for the restriction	Comment
<p>Note: This is one of the investment functions referred to in Row 4 below.</p>		
<p>4. Liability for breach of an obligation under any rule of law to take care or exercise skill in the performance of any investment functions (the “Investment Skill and Care Duty”), where the function is exercisable:</p> <p>(a) by a trustee of a pension fund, or</p> <p>(b) a person to whom the function has been delegated as permitted by Section 34 of the Pensions Act 1995 (e.g. an investment manager),</p> <p>cannot be excluded or restricted by any instrument or agreement.</p> <p>Note: Not a direct constraint but it informs the legal advice to the trustee and trustee behaviour.</p>	<p>Section 33 of the Pensions Act 1995</p>	<p>4.1 Section 33 is not, as such, a constraint on trustee investment powers.</p> <p>4.2 However, in terms of prudent personal liability risk management by the trustee, the legal advice to the trustee will be to err on the side of caution so as to avoid, inadvertently, having the trust assets invested outside of the trustee’s investment powers.</p> <p>4.3 It should be noted that neither the agreement of the employer nor of any member can authorise the trustee to invest outside its investment powers (because such agreement is rendered invalid by Section 33 of the Pensions Act 1995).</p> <p>4.4 In a defined benefit scheme, an employer indemnity⁶ in favour of the trustee for liability incurred for breach of the Investment Skill and Care Duty will also be rendered void by Section 33 (see Section 33(2)) on the basis that:</p> <p>(a) the employer is generally the residual beneficiary under the pension fund if there are surplus assets, and</p> <p>(b) in any event, the trustee, when investing the pension fund assets, has a duty of care to the employer in a defined benefit pension scheme (because it is the employer that has to make up any shortfall in the funding required to provide the benefits for the members).⁷</p>
<p>5. Constraint that the trustee must exercise its investment powers for the purpose for which they were given.</p>	<p>The most recent case confirming this trust law rule as to how a trustee power is to be exercised is to be found in the Court of Appeal decision given on 5th July, 2018 (British Airways Plc v Airways Pension Scheme Trustee Limited).</p> <p>Note: This is not a case about investment powers, but affirms this most important trust law constraint on the powers of trustees.</p>	<p>5.1 This important trust law constraint restricts what might otherwise be taken, at face value, as being very wide powers of the trustee as to how the pension fund assets should be invested.</p> <p>5.2 In other words, it is directly in point in relation to the extent to which “non-financial matters”⁸ may be taken into account by the trustee.</p>
<p>6. Constraint that the trustee is required to act as a “prudent person” exercising investment powers. In other words, the trustee must:</p>	<p>6.1 The quoted text is set out in Cowen v Scargill, a decision of Sir Robert Megarry V-C given on 4th April, 1984 in turn quoting from Learoyd v Whiteley (1987) 12 App Cas 727.</p>	<p>6.1 On the basis that the “prudent personal rule” as used in the IORP I Directive and IORP II Directive has the same meaning as the prudent personal rule currently part of English law, there is no conflict between the EU Directives and English law.</p>

⁶ But remember that an indemnity by a company in favour of its directors (or the directors of another group company) where the company in question is acting as trustee of the pension scheme, is rendered invalid by the Companies Act 2006, Section 232 but subject to the carve-out for an indemnity meeting the requirements of Section 235 of that Act (Qualifying pension scheme indemnity provision) where the company in question is subject to the Companies Act 2006 provisions.

⁷ See for example the Association of Pension Lawyers Prestige Lecture 2015 delivered on 9th September, 2015 by Mr Justice Christopher Nugee, on “The duties of the pension scheme trustees to the employer – Revisited” at, for example, paragraph 13-16

⁸ “Non-financial matters”, in this response to the Consultation Paper, has the same meaning as in the Draft Regulations where they are defined as including “(but is not limited to) ethical matters, social impact matters and present and future quality of life of members’ matters”.

Constraint	Legal authority for the restriction	Comment
<i>"take such care as an ordinary prudent man⁹ would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide".</i>	6.2 See also the requirement of Article 18 of Directive 2003/41/EC (the "IORP I Directive") and Article 19 of Directive 2016/2341 (the "IORP II Directive") ¹⁰ .	<p>6.2 It should, however, be noted that the "prudent person rule" also has meaning under US law.</p> <p>6.3 It is outside the scope of this summary to comment on remedies for non-transposition of a Directive requirement into English law.</p> <p>Note: The author understands that there is no analysis of how the "prudent person rule" is to be defined under European law that provides any more detail (personal communication to the author by Professor Dr. Hans van Meerten, Professor of EU Pensions Law at Utricht University).</p>
7. Additional constraints imposed by the statutory restrictions and obligations on exercise of investment powers	Section 36(1) of the Pensions Act 1995 and the Occupational Pension Schemes (Investment) Regulations 2005 (the "Investment Regulations"), Regulation 4.	<p>Amongst the restrictions and requirements in Regulation 4 are:</p> <p>7.1 the requirement to invest the assets of the pension scheme in the best interests¹¹ of the members (but this must be read subject to the proper purpose rule referred to in Row 5 above and the prudent person rule referred to in Row 6 above), and</p> <p>7.2 in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole.</p> <p>Note 1: As set out in Row 3 above, there is also an obligation to invest with a view to giving effect to the principles contained in the pension scheme's statement of investment principles so far as reasonably practicable.</p> <p>Note 2: Regulation 2(3)(b)(vi) of the Investment Regulations currently says that the statement of investment principles must also specify:</p> <p><i>"the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments".</i></p>
8. Duty to "fess up" to breaches of the statement of investment principles Note: Not a direct constraint but it informs the legal advice to the trustees and trustee behaviour.	The Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013, Schedule 3, paragraph 30.	<p>8.1 This duty to "fess up" makes the trustees a "sitting duck" for a claim by any member against the trustees that they have acted in breach of their statutory duty under Section 36(5) of the Pensions Act 1995 as referred to in Row 3 above (and the Section 36(5) duty is one of the trustee's investment functions).</p> <p>8.2 In other words, from a legal risk management point of view, this strongly reinforces the need for a statement of</p>

⁹ This would, these days, be read a "person" but the quote comes from a 19th Century case.

¹⁰ The IORP I Directive is repealed by the IORP II Directive with effect from 13th January, 2019. To the extent not already part of UK law, the requirements of the IORP II Directive would need to be transposed into UK law by 13th January, 2019.

¹¹ The better view is that the duty to act in the best interests of members is a short hand for a bundle of duties including a duty to invest in accordance with the proper purpose requirement, referred to in **Row 5** of **Table 1**. See, for example, the judgment of Asplin J given on 25th February, 2015 in *Merchant Navy Ratings Pension Fund v Stena Line* at paragraphs 228 to 243.

Constraint	Legal authority for the restriction	Comment
		investment principles to be written in broad generic terms.

2. Some points on legal risk management

- 2.1 Where pension scheme trustees seek legal advice in relation to investments, the author would expect a legal adviser to consider the matters referred to in **Table 1** above (depending on the nature and scope of the advice requested).
- 2.2 An aspect of providing legal advice to pension scheme trustees is to manage the risk of the trustees incurring personal liability; particularly given the way Section 33 of the Pensions Act 1995 works:
- (a) to disapply the usual exculpation clause in a trust deed which, in summary, generally absolves trustees¹² (other than paid professional trustees) from liability so long as they have acted in good faith, and
 - (b) the fact that Section 33 removes the indemnity¹³ often provided by the employer to the trustees (other than paid professional trustees) for any liabilities which they may incur so long as they have acted in good faith.
- 2.3 The position on legal risk management in this area has been elegantly summarised as follows:

“(a) General Dos And Don’ts

In many jurisdictions pension fund fiduciaries must disclose whether, and if so how, ESG factors are incorporated into investment policies. Here are some dos and don’ts.

- *Get the disclosures checked by a lawyer.* Any written statement can and will be used in evidence in any matter where a proper understanding of fiduciary duty is in issue. It is expected fiduciaries will engage with their actuarial consultants and investment professionals, but the final copy should be reviewed by a lawyer.
- *Keep the disclosure short and to the point.* Four or five sentences should be sufficient for most pension funds, except possibly larger funds that engage in direct investments and more sophisticated investment consortia or investment structures. More documentation will be required to support particular actions that are taken, but that will usually be in the form of minutes of particular decisions.
- *Never say ‘never.’* Fiduciary duty requires pension fund fiduciaries to consider relevant factors. If a relevant ESG factor is brought to the attention of the pension fund fiduciaries, they should not ignore it. If fiduciaries determine that they will not consider ESG factors, they better explain it.
- *Don’t get too specific.* Fiduciary duty requires factors relevant to financial performance and financial risk mitigation to be considered and others to be ignored. Many factors are contextual and cannot be

¹² The author acknowledges that most large pension funds have, as their sole trustee, a single purpose company, usually with a share capital of £2. It is outside the scope of this response to comment on the personal liability of the directors of such a company in detail.

¹³ The practical rule of thumb, when advising, is to assume the directors are in the same position as individual trustees for the purpose of applying Section 33. An additional point to bear in mind is that Section 232 of the Companies Act 2006 invalidates indemnities given by companies within the scope of that Act in favour of their directors (or in favour of directors of other group companies). There is, however, a carve-out in Section 235 of the Companies Act 2006 from Section 232 where the indemnity in question satisfies the requirements in Section 235 to be a qualifying pension scheme indemnity provision.

anticipated. A general reference is less likely to provide evidence that fiduciaries unreasonably restricted their discretion or ignored or excluded relevant ESG factors that arose after development of a policy statement. A general reference should be interpreted as including the broadest range of ESG factors, so fiduciaries might consider referencing whatever radar system they have in place for picking them up, rather than the factors themselves.

- *Don't confuse ESG investment practices with SRI or ethical investing.* If fiduciaries engage in SRI, then among other things, they better make sure foundation documents or other legal parameters support it. Where SRI is taken into account, fiduciaries might also indicate that they appreciate the differences between pure ESG factor integration and SRI and provide some reasons to demonstrate that they are properly exercising their fiduciary duty and not violating the usual duty to act in the best financial interests of plan members."¹⁴

3. **The “value add” of the statement of investment principles (including the additional changes proposed to the draft regulations)**

- 3.1 It must be remembered that both time and money are finite.
- 3.2 This is true for a trustee board and their pension fund as for any company carrying on a business or any government.
- 3.3 Every pound spent on adviser fees in relation to a statement of investment principles is £1 of additional cost for the employer (not the members) in relation to a defined benefit scheme.
- 3.4 Likewise, for a money purchase scheme, each additional £1 spent on adviser fees in relation to a statement of investment principles is an additional £1 of cost to be deducted from the retirement account of the member of the money purchase pension scheme.¹⁵
- 3.5 In the author's view:
 - (a) the changes proposed by the Draft Regulations will, in terms of risk management, be dealt with by the use of generic bland statements, and
 - (b) from a value added perspective, given a finite budget, will be, in general, relatively standardised.
- 3.6 That said, there will be issues raised by a particular interest group which may well consume considerable time and resource of the pension fund trustees and, in defined benefit schemes, the sponsoring employer in dealing with the claims brought by the special interest group.
- 3.7 For a recent example see the Court of Appeal decision given on 6th June, 2018 in The Queen on the Application of Palestine Solidarity Campaign Ltd and Jacqueline Lewis v The Secretary of State for Communities and Local Government¹⁶.

¹⁴ “Managing Environmental, Social and Governance (ESG) Factor Integration”, paper presented on 4th June, 2018 at the 31st International Congress of Actuaries in Berlin by Randy Bauslaugh, partner in the Canadian law firm McCarthy Tétrault and Dr. Hendrik Garz leader of Sustainalytics’ Global ESG Rating Products & Thematic Research teams.

¹⁵ Unless the employers agree to pick up that cost.

¹⁶ The case was about guidance given by the Secretary of State for Communities and Local Government in relation to the investment strategy of authorities administering local government pension schemes and whether the following guidance was lawful: “*However, the Government has made clear that in using pension policies to pursue boycotts, divestment and sanctions against foreign nations and UK defence industries are inappropriate, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government*”.

- 3.8 To the extent that the costs of this litigation were not recovered from the parties bringing the litigation, it should be noted that those costs are borne by the tax payer.
- 3.9 Because of the strength of the “prudent person rule” (see **6** below), trustees and their fund managers who do not give appropriate weight to financially material ESG (and other) factors material to their investment strategy (and which can be evaluated and taken into account on a cost effective basis) are already in breach of their fiduciary duties.
- 3.10 Additional disclosures in the statement of investment principles, in the author’s view, are:
- ♦ unlikely to have an impact on trustee behaviour, and
 - ♦ because of the recurring need to manage legal risk,
- are likely to carry with them rather greater compliance costs than are assumed in the DWP’s Cost Impact Assessment of the proposed changes to be made by the Draft Regulations.

4. **Difficulty with Law Commission conclusion on the extent to which trustees of a pension fund may take account of members’ wishes and whether that conclusion is correct in law**

- 4.1 Paragraph 24 of the Consultation Paper provides a clear summary of the Law Commission’s view on this topic as follows:

“24. As the Law Commission have emphasised, the ability to take account of member’s wishes is permissive, and then only when the 2-stage test set out below is met:

- firstly, trustees should have good reason to think scheme members hold a concern; and
- secondly, the decision should **not** involve a **significant financial detriment**.”

My emphasis

- 4.2 In practice, the question as to what is or is not a “significant financial detriment” moves from being a qualitative concept to require quantification when giving practical legal advice.
- 4.3 Let us suppose that an investment strategy adopted by the trustees to take account of members’ views is expected to reduce the return on the investment by x basis points¹⁷.
- 4.4 The trustee then asks the legal adviser to advise on what value may be accorded to x basis points.
- 4.5 Let us do the following thought experiment in which we assume:
- ♦ under the first investment strategy the trustee would have expected a target investment return of 5% a year, and
 - ♦ under the second investment strategy (taking account of member concerns but avoiding a significant financial detriment) that the return is reduced from 5% to 5% - x basis points.
- 4.6 What answer is the legal adviser to give to this question?

¹⁷ There are 100 basis points in 1% (so 50 basis points corresponds to ½ %).

- 4.7 **Table 2** below looks at the return on an investment portfolio with a starting value of £1 million invested with various levels of investment return over a 20 year period in order to provide an example of the difficulty of giving legal advice as to at what point a financial detriment has become significant.

Table 2

	Amount of initial starting portfolio	Percentage investment return achieved per annum	Value of portfolio after 20 years
1.	£1 million	5%	£2,653,295
2.	£1 million	4.9%	£2,603,213
3.	£1 million	4.8%	£2,554,028
4.	£1 million	4.7%	£2,505,726
5.	£1 million	4.6%	£2,458,293
6.	£1 million	4.5%	£2,411,714

Note: Please note that, in the interests of simplicity, no allowance has been made for the effect of inflation.

- 4.8 As may be seen from **rows 2 to 6** above, each row shows a reduced return of 10 basis points from the row above it. In money terms, this works out at a reduction of about £50,000 per 10 basis points.
- 4.9 As there is no case law or legislation that can be applied to this example, in terms of legal risk management (and bearing in mind the way Section 33 of the Pensions Act 1995 works – see **Table 1, Row 4**), the practical legal advice provided to the trustee is that it would not be prudent for you to take on this risk. **In other words, the legal advice is going to be that x basis points should have a value of zero.**
- 4.10 Furthermore, in the author's view, the Law Commission's analysis of the law in this area is not supported by the case law from which it derives and, until affirmed as correct by a Court, cannot, in the author's view, be safely relied on.
- 4.11 The reasons for this are set out in more detail in **Annex A**. But the key points are as follows:
- ♦ the test set out at **4.1** above comes verbatim from a case called Harries v Church Commissioners which was a case involving the investment of assets of a charity (as distinct from the investment of assets of a pension fund).
 - ♦ this point was specifically acknowledged by the judge in that case in which he distinguished the trusts of the assets administered by the Church Commissioners as being different from the trusts of a pension fund which were the subject of the judgment in Cowen v Scargill.
 - ♦ Cowen v Scargill is a judgment given on 4th April, 1984 at a time when there was no statutory obligation on an employer to fund a pension scheme deficit and no consideration was, accordingly, given to the duties owed by the pension fund trustees when investing to the employer.

4.12 In relation to a defined benefit pension scheme, it is generally well recognised that trustees have a duty to take account of the interests of the employer¹⁸ in the exercise of their powers. A recent example is the judgment of the Court of Appeal given on 4th July, 2018 in British Airways Plc v Airways Pension Scheme Trustee Limited.

4.13 Another example is in the Merchant Navy Ratings Pension Fund v Stena Line case (judgment given on 25th February, 2015) at paragraph 231 where Asplin J says:

“Nevertheless, it is quite clear from the extracts from the Judgment of Chadwick LJ¹⁹ to which I have referred, that it was considered perfectly legitimate to consider the interests of the Employers in that case and that the continued viability of the Employers was something which the trustees were entitled to promote.”

4.14 In other words:

- ◆ in terms of practicality of applying the Law Commission test referred to at **4.1** above, and
- ◆ in terms of whether it is legally sound, and
- ◆ in terms of taking account of the interests of employers (where the starting presumption is that additional cost to the employer should be avoided rather than to impose cost on the employer and give the members a “free ride”),

these factors all point to the conclusion that taking account of the members’ views, unless they have the effect of drawing to the attention of the trustees a material financial factor, is not a course of action that trustees can lawfully take.

5. **Raising of false expectations**

5.1 In my view, the Law Commission’s conclusion referred to in **4.1** above on the extent to which the views of members can be taken into account has been the basis for raising false expectations and carries with it the scope for time and money being spent when there is no justification for doing that.

5.2 It follows that a statement as to whether trustees have taken account of the views of members (or have obtained the views of members), should be answered in the negative for any defined benefit pension scheme.

5.3 As is discussed in **8** below, the same is also valid in relation to the default investment option for money purchase schemes.

5.4 As always, if it is the wish of Parliament to change the law so as to require the law to be what the Law Commission has considered the law to be as set out in **4.1** above, it remains open to Parliament to make that change (if that is the policy intention).

6. **The strength of the prudent person rule**

¹⁸ See for example the Association of Pension Lawyers Prestige Lecture 2015 delivered on 9th September, 2015 by Mr Justice Christopher Nugee, on “The duties of the pension scheme trustees to the employer – Revisited” at, for example, paragraph 13-16

¹⁹ Decision of the Court of Appeal in *Edge v The Pensions Ombudsman*.

- 6.1 The author agrees with the Law Commission's conclusion that the prudent person rule already requires trustees to take account of any material factor (whether ESG or not):
- (a) which the trustee properly considers will affect the return on the assets to the pension fund relative to its time horizon and to the investment strategy of the pension fund, and
 - (b) which can be evaluated in a proportionate and cost effective manner by or on behalf²⁰ of the trustees.
- 6.2 In other words, if the factor is material to the achievement of the investment objective and meets the tests in **6.1(a)** and **(b)** above, then the prudent person rule would require account to be taken of that factor.
- 6.3 From a trustee decision taking perspective, there will be a number of factors identified by:
- ♦ the trustees' investment consultant,
 - ♦ by the trustees' investment manager, and
 - ♦ by the trustees themselves,
- as material to the achievement of the investment objectives of the pension fund (or the relevant portfolio of the pension fund assets in question).²¹
- 6.4 In any multi-factoral analysis, appropriate weightings need to be given to factors which have been identified as material taking account of cost of evaluating and assessing the materiality of the factor.
- 6.5 Furthermore, the more difficult it is to obtain information relevant to the evaluation of the factor in question and its impact on the investment of the assets in question, the greater the likelihood that the factor in question will be accorded a lower (or no) weighting.
- 6.6 Where information about factors that may impact on the long term value of investments in a particular company are readily available and in a relatively standard format, the costs and effort required to obtain that information about the company in question (and the associated time and cost of analysing that information to feed into the investment decision making process) is much reduced.
- 6.7 In other words, a more fruitful approach for seeking to implement some of the policy considerations behind the Consultation Paper may well be based on requiring companies above a certain size to provide in a suitably standardised format the information identified as material.

7. **Let's avoid being hypocritical in this area**

- 7.1 It should be noted that in the tax year ending 6th April, 2017:
- ♦ UK tax revenues from tobacco duty were £8,909 million, and

²⁰ E.g. by the investment manager to whom the trustee has delegated the investment management of the portfolio of pension fund assets in question.

²¹ It would be theoretically possible for a member or group of members to have identified, and raised with the trustees a material factor for these purposes. If so, it would be evaluated in accordance with the test set out in **6.1** above.

- ◆ UK tax revenues from betting duty were £2,742 million.²²

7.2 It should also be noted that:

- ◆ there is not inconsiderable controversy over whether there should be a third runway at Heathrow Airport and there are linked issues as to the environmental impact of the third runway, but
- ◆ airports are seen as infrastructure and pension fund are amongst the investors in a number of UK airports²³.

7.3 In other words, care is needed in this area to avoid hypocrisy.

8. **Default funds in money purchase schemes or money purchase sections of the defined benefit schemes and taken account of member views**

8.1 Government policy, quite correctly, has been to both cap the charges on default funds in money purchase sections of DB schemes and in pure money purchase schemes²⁴.

8.2 The rationale of this is entirely valid. It reflects the fact that:

- ◆ the more money that goes out in charges the less money there is available to the member at retirement, and
- ◆ in the region of 92% of members of money purchase pension schemes (to which the Occupational Pension Schemes (Charges and Governance) Regulations 2015 apply in relation to the charge cap on default investment options) are in the default investment option²⁵.

8.3 It should also be noted that for many members of a money purchase scheme, the current amounts being contributed to the money purchase scheme are unlikely to provide an adequate retirement income.

8.4 Again, the comments and analysis in **Section 4** above in relation to defined pension schemes apply equally, with one adjustment, to default investment options in money purchase schemes. That one adjustment is that it is the interests of the members in the default fund that are relevant rather than the interests of the employer.

8.5 But this is not a case where it is expected that most members of money purchase schemes will have saved enough for a comfortable retirement and so can afford to be “touched up” for a reduction, even a non-financially significant reduction, in investment returns.

8.6 **Table 3** below is a repetition of **Table 2** but with the amount of the member’s retirement account scaled down from £1 million to £100,000 to help illustrate the impact of additional costs being charged to the member’s retirement account.

²² <https://www.uktradeinfo.com/Statistics/Pages/TaxAndDutybulletins.aspx>

²³ Private Eye reports that a large UK pension fund and a large Canadian pension fund would be amongst the investors providing finance for the third runway at Heathrow Airport (see Private Eye No. 1474, 26th July, 2018, page 8).

²⁴ As implemented by the Occupational Pension Schemes (Charges and Governance) Regulations 2015.

²⁵ The Pensions Regulator: Presentation of scheme return data 2016/2017 for DC trusts (<http://www.thepensionsregulator.gov.uk/doc-library/dc-trust-presentation-of-scheme-return-data-2017.aspx>)

Table 3

Amount of initial starting portfolio	Percentage investment return achieved per annum	Value of portfolio after 20 years
1. £100,000	5%	£265,329.5
2. £100,000	4.9%	£260,321.3
3. £100,000	4.8%	£255,402.8
4. £100,000	4.7%	£250,572.6
5. £100,000	4.6%	£245,829.3
6. £100,000	4.5%	£241,171.4

Note 1: Please note that, in the interests of simplicity, no allowance has been made for the effect of inflation.

Note 2: The member will not start with an initial retirement account balance of £100,000. But he will have, more likely than not, an investment time horizon where in excess of 20 years.

Note 3: In other words, a ten basis points reduction in return net of charges will reduce the member's retirement account by about £5,000 in this simplified example. The purpose of the example is to provide context and scale.

8.7 It should also be remembered that contributions to tax approved pension schemes receive tax relief.

8.8 So, insofar as there are additional charges borne by the default fund or there is a reduction, even if "not financially significant", in the investment return, insofar as that is made up by additional contributions, there will be tax relief granted on those contribution which will either have to reduce public expenditure elsewhere or be funded by additional taxation.

9. **One member one view or one pound one view**

9.1 When undertaking a survey of the views of individuals, it may be said that it is one individual one view.

9.2 However, if we look at voting rights of shareholders in companies, in general it is one vote per share. So the more shares you have the more votes you have.

9.3 For example, if you hold one share you have one vote. If you have 1,000 shares you have 1,000 votes.

9.4 Insofar as additional costs are incurred or investment performances reduced, there is a line of argument which says that as the property rights of individuals are being affected (adversely), weightings of views should reflect the value at risk of each member in the pension scheme by reference to the size of his or her "DC pot" or retirement account in the pension scheme.

10. **The dangers of framing of the questions in surveys**

10.1 In general, most people in the UK are in favour of building more houses.

10.2 However, the number of those in favour of building new houses in a location close to where the person being surveyed lives declines rapidly.

10.3 It is the author's contention that member surveys about investing to take account of particular factors of a social nature which are presented as a free option will, unsurprisingly, obtain substantial support.

10.4 However, if the member is told that:

- ◆ a particular investment strategy would over a 20 year period reduce the value of the member's retirement account at the time when it is converted into retirement income from £200,000 to £195,000 (a £5,000 reduction), or
- ◆ the additional costs charged to the member's retirement account as a result of the additional compliance burdens of complying with the Draft Regulations (or of taking account of members' views), would reduce the member's retirement account from £200,000 to £195,000, a reduction of £5,000,

it is the author's contention that the number of members who are willing to accept that reduction will be very much in the minority (while recognising that there will be those who hold strong convictions and who are prepared to put their money where their mouth is).

10.5 Any surveys in this area need to be carefully structured to avoid leading the member to a particular conclusion (while recognising the difficulties in this area of the way in which human beings process information).

C. Responses to the 11 specific questions

Note: Each of the 11 sections below reproduces, in the first part of the section, the question and the second part of the section sets out the response to the question.

1. Question 1 and Response

1.1 **Question:** 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?
- (b) Do you agree that the draft Regulations meet the policy intent?

1.2 **Response:** Yes, but subject to the general caveat as to whether the approach in the draft Regulations is the best way of achieving the policy objectives.

2. Question 2 and Response

2.1 **Question:** 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?
- (b) Do the draft Regulations meet the policy intent?

2.2 **Response:**

Policy

2.2.1 In the light of what is explained in **Section B2** above (on legal risk management), my expectation is that:

- ◆ the policy will be good for generating fees for investment consultants and lawyers,

- ◆ will increase costs for employers in relation to defined benefits schemes,
- ◆ will reduce the size of members' retirement accounts in money purchase schemes, and
- ◆ will, in consequence, be of limited utility.

2.2.2 In my view, the better way of removing legal doubts (which, in my view, do not exist) as to whether ESG and other factors should be taken into account by pension scheme trustees where they are financially material (and pass the test set out in **B6** above) would be as follows:

- (a) to modify Section 33 of the Pensions Act 1995 to include an express defence to a breach of the Investment Skill and Care Duty²⁶ claim to cover the situation where the trustee has taken account of both
 - (i) financially material considerations²⁷, and
 - (ii) “non-financially matters”²⁸, and
- (b) where the trustees, acting as prudent persons, consider them to be financially material to the investment objective of the pension fund.

Note 1: An approach along these lines is followed in the Manitoba Trustee Act in Section 79.1²⁹.

Note 2: This would then provide a clear “safe harbour” and dispose completely of any doubts or misconceptions that may still exist over whether factors (of whatever type) material to the proper exercise of an investment power can be taken into account.

Note 3: There is a power in Section 33(3)(b) of the Pensions Act 1995 to make this change via secondary legislation.

2.2.3 In my view, this would substantially reduce compliance costs and avoid distractions in trustee board time from other more important issues.

Drafting

2.2.4 In relation to the Draft Regulations I would recommend on the current definition of “financially materially considerations” be amended to read:

“Financially material considerations” includes (but is not limited to) environmental, social and governance

²⁶ For definition, see **Table 1, Row 4**.

²⁷ As defined in the Draft Regulations **but with the addition of the words in red recommended in 2.2.4.**

²⁸ As defined in the Draft Regulations.

²⁹ See <http://web2.gov.mb.ca/laws/statutes/display2.php?p=&f=ccsm%2Ft160e.php&query=79.1>

*considerations (including climate change) **insofar as the trustees determine that such considerations are financially material to the attainment of the purposes of the pension scheme (and not for any ulterior or extraneous purposes)***".

Comment: Without the additional wording in red, the wording drops back into conflating the 2 concepts:

- ◆ financially materially considerations, and
- ◆ considerations which are not financially material,

and suggests that all environmental, social and governance considerations are financially materially when only some are financially material to the pension scheme in question.

3. **Question 3 and Response**

3.1 **Question:** 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?
- (b) Do the draft Regulations meet the policy intent?

3.2 **Response:**

Policy

3.2.1 In my view, no.

3.2.2 As noted in **Section B** above, where the pension scheme is a defined benefit scheme, the views of the scheme members are not relevant except in the very limited situation where the members identify a financially material factor which has been missed by the trustees' investment and other advisers (and which passes the test set out in **Section B6.1** above). The member receives a pension from the pension scheme. The employer is responsible for providing the funding to provide the pension. The way in which the assets of the pension scheme are invested directly (and the costs incurred by the trustee) impacts on the cost to the employer.

3.2.3 To illustrate this point another way, if a member buys an annuity, the way in which an insurance company invests the premium to purchase the annuity is a matter for the insurance company. The member has paid the premium and the other side of the bargain is the provision of the annuity.

3.2.4 In relation to the default investment option for a money purchase pension scheme, the member is in the default investment option because the member has made no choice.³⁰

Note: See the comments in **Section B** above, including **Section B2, B3 and B8** in terms of value add and costs.

³⁰ As noted in **Section B8** above, the data collected by the Pensions Regulator is to the effect that 92% of members in schemes covered by the Occupational Pension Schemes (Charges and Governance) Regulations 2015 are in the default investment option.

3.2.5 The practical point here is that:

- ◆ if any particular member or group of members has a strong view, then that view will be communicated to the trustee by the members concerned, and
- ◆ the trustee may, where properly exercising its prudent person duty, wish to accommodate the members' view, within the powers available to the trustee under the trust deed, by including an investment option, where appropriate and cost effective, for members of a money purchase scheme which allows the members in question to have their retirement accounts invested in accordance with their personal preferences and at the cost of those members.³¹

3.2.6 Such an approach would avoid the additional cost to the trustees of adjusting their statement of investment principles.

3.2.7 By way of real life example which was reported to me by one pension fund, some active members of a pension fund requested the introduction of a "ethical" investment option. The trustee organised a survey of the active members of the pension fund (in relation to which employer contributions were being paid to their retirement accounts). As the survey was conducted amongst current active members, it could be dealt with easily by email. In light of the response received to that survey, and with the support of the employer, appropriate steps were taken to introduce the additional investment option. But, the key point here, is that this was promoted by the active members and the employer, in effect, financed the costs of the exercise.

Comment: For deferred members, the deferred member has a statutory right³² to transfer to, for example, a personal pension scheme which provides the particular investment option that the member is interested in.

Drafting

Not applicable.

4. Question 4 and Response

4.1 **Question:** 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?

4.2 **Response:**

4.2.1 I agree with your response for the reasons you have given in the Consultation Paper and also having regard to the matters referred to in **Section B** above (and in particular the trustee's investment duties as summarised in **Table 1** of **Section B** above).

³¹ The prudent person rule and the scope of the trustee powers will temper the wishes of some members to invest all of their retirement accounts in bitcoins.

³² Under the Pension Schemes Act 1993, Part 4ZA.

- 4.2.2 If the trustees, usually via their investment managers or investment advisers, consider that social impact investing is a useful diversification risk and provides a commercial rate of return, then the trustees can, applying the prudent person rule and the test set out in **Section B6.1** above, invest in social impact investments.
- 4.2.3 However, it is important to remember that the purpose of the pension fund is to provide pensions and other retirement benefits for members. That purpose is encouraged by tax deductions. The pension fund is not the “magic money tree” that can finance good causes which do not satisfy the prudent person rule and the test set out in **Section B6.1** above.

Note 1: Where an employer pays an employer contribution to a tax approved pension scheme, in general the employer will obtain a tax deduction at its marginal rate of tax. Similarly, if the member is paying contributions, the member would obtain, in general, a tax deduction at the member’s marginal rate of tax.

Note 2: In other words, to encourage retirement saving, Parliament encourages that retirement saving through the grant of tax relief.

Note 3: The tax payer, accordingly, has an interest in employer and member contributions being used for their proper purpose of providing retirement benefits in a cost effective and efficient manner.

Note 4: If Parliament wishes to encourage social impact investment by pension funds on non-commercial terms, then it is, as always, the right of Parliament to legislate to enable that to happen.

5. Question 5 and Response

5.1 **Question:** 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?
- (b) Do the draft Regulations meet the policy intent?

5.2 **Response:**

Policy

- 5.2.1 Under the prudent person rule, the trustee is already required to engage in stewardship activities to the extent that these can be dealt with on a proportionate, cost effective and value adding basis. For example, if the cost of exercising voting rights in relation to certain investments in the portfolio outweigh the expected “value add” then it is proper for the trustee not to expend trust assets (and increase costs to employers in defined benefit schemes and reduce benefits for member’s money purchase schemes) if that is disproportionate to the value added.
- 5.2.2 That said, for the legal risk management reasons referred to in **Section B2** above, statements are likely to be of a generic nature with the implementation and execution of the policy being, in large part, delegated, in the interests of time and efficiency, to the investment manager or proxy voting service provider or engagement service provider.

- 5.2.3 I am relatively agnostic as to whether this change is a good use of time and money. In any event, larger pension funds are already including statements along these lines in their annual reports in my experience.
- 5.2.4 One approach would be to include this requirement, but only in relation to pension funds with assets in excess of £2 billion.

Drafting

- 5.2.5 In my view the draft Regulations meet the policy intent.

6. Question 6 and Response

- 6.1 **Question:** 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?
- (b) Do the draft Regulations meet the policy intent?

- 6.2 **Response:**

Policy

- 6.2.1 In the light of my response to **question 3** above, it follows that there should be no obligation on the trustees to solicit or take account of members' views.
- 6.2.2 As noted in response to **question 3** above, if members do have views they can make them know to the trustee and the trustee can then evaluate whether those views are ones which they can lawfully give effect to (but, as always, forming a judgment as to whether this is a good use of trustee time and employer money for defined benefit pension schemes or member money for defined contribution pension schemes where the costs are borne by the member's retirement account).

Drafting

- 6.2.3 In light of the comments on the policy decision, it follows that I have no comments on the drafting.

7. Question 7 and Response

- 7.1 **Question:** 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?
- (b) Do the draft Regulations meet the policy intent?

- 7.2 **Response:**

Policy

- 7.2.1 I agree that the information should be published online (but with the modification as to what information should be made available as indicated in the responses to the earlier questions).
- 7.2.2 I also agree that the fact that this information is available online should be included in the annual benefits statement.

Drafting

- 7.2.3 With the caveat about what information should be made available as noted in responses to the earlier questions, I consider the draft Regulations meet the policy intention.

8. Question 8 and Response

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

- 8.2 **Response:**

Policy

- 8.2.1 Except in relation to matters covered by **question 5**, in relation to defined benefit pension schemes, the business burdens and costs are disproportionate to the benefits (for the reasons noted earlier in this response, including, in particular, **Section B**). As previously mentioned, in a defined benefit scheme the member receives the pension irrespective of how the assets of the pension fund are invested, so long as the employer is not insolvent. The employer, so long as solvent, picks up the cost.
- 8.2.2 The employer is consulted on the SIP in relation to a defined benefit pension scheme and has an extremely keen economic interest in the success of the investment of the schemes assets and the process of successful investment of those assets by reference to the investment objective on which the employer has been consulted by the trustee.
- 8.2.3 As noted earlier in this response, trustees should, under the prudent person rule, be taking account of all material factors which pass the test outlined in **Section B6**.
- 8.2.4 The Government's policy under the Occupational Pension Schemes (Charges and Governance) Regulations 2015 relating to value for money and the charge cap for default funds is, in my view, correctly focussed on the right issues.
- 8.2.5 For the legal risk management reasons referred to in **B2** above, statements to members are likely to be generic and high level.
- 8.2.6 One particular point to draw out in your draft impact assessment is that the likelihood, in my experience, of trustees actually reading any legislation is extremely low. Instead, the pensions manager will, in conjunction with the advisers to the Trustees, take responsibility for dealing with these matters.
- 8.2.7 Because of the need to manage legal risk (as discussed in **B2** above), my expectation is that the overall costs, in terms of professional advice, are likely to be higher than those assumed in the impact assessment. **Please note, these costs are recurring costs (and not one-off costs). They recur every time the statement of**

investment principles is revised and are additional to the existing legal risk management costs.

- 8.2.8 As noted in the response to question 2, a more fruitful way of achieving at least some aspects of the policy would, in my view, be to follow an approach similar to the Manitoba Trustee Act, Section 79.1 by way of modification to Section 33 of the Pensions Act 1995. (For further details see the response to **question 2**.)
- 8.2.9 As noted earlier, there is power to make this change via secondary legislation under Section 33(3) of the Pensions At 1995.

9. Question 9 and Response

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

9.2 **Response:**

- 9.2.1 In my view it is important to remember that the purpose of pension schemes is to seek to ensure a decent level of retirement income for pensioners.
- 9.2.2 Pension schemes are not a “magic money tree” to be used for the purpose of “saving the world”.
- 9.2.3 That said, it must be remembered that, given the long term nature of the obligations of the pension scheme, the pension scheme trustee (and employer) need to take account of changes in the environment in which they operate which could increase risk or destroy value.
- 9.2.4 Climate change, for example, is a very important factor to consider. The extent to which it is material to the management of risk or the increase in investment return for any particular pension scheme is a matter of judgment for the trustee of that pension scheme and its investment managers and relevant advisers (because, under the prudent person rule, it is a factor that needs to be evaluated).
- 9.2.5 As to whether the factor is material to the particular pension scheme and the approach to be adopted by that particular pension scheme will turn on the specifics of the pension scheme in question (and having regard to the test in **Section B6** above):
- (a) for example, if the pension scheme is aiming to invest all of its assets in government bonds in preparation for a buy-in or buy-out, then it is not going to be a proper use of trustee time and associated employer money to lobby government (or former government) ministers to lie down in front of bulldozers to reduce the environmental impact, for example, of building an additional runway at a major London airport.
 - (b) for example, if the pension fund is considering investing in infrastructure (or an infrastructure fund) which, in turn, is one of the co-investors in an airport³³, then evaluation of regulatory risk and climate change risk becomes highly relevant so that:

³³ Private Eye reports that a large UK pension fund and a large Canadian pension fund would be amongst the investors providing finance for the third runway at Heathrow Airport (see Private Eye No. 1474, 26th July, 2018, page 8).

- (i) if the airport is exposed to flooding, that will reduce revenue and increase maintenance costs, and
- (ii) the government of the day may increase air passenger duty to levels designed to reduce the number of flights, or
- (iii) the government of the day may impose restrictions on the number of flights in order to comply with carbon emission targets.

10. **Question 10 and Response**

- 10.1 **Question:** 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?
- 10.2 **Response:** Yes, subject to the qualification as to what information should or should not be required to be provided in the Draft Regulations as indicated in the earlier responses given.

11. **Question 11 and Response**

- 11.1 What evidence or views do you have of how well the other requirements in the SIP are working? What areas for further consideration and possible future change would you suggest?
- 11.2 **Response:**
- 11.2.1 For the reasons indicated in **Section B2** and **Section B3** above, I do not consider, with the possible exception covered in my response to **question 5**, that any additional changes to Regulation 2 of the Occupational Pension Schemes (Investment) Regulations 2005 (relating to content of the SIP) are needed.
- 11.2.2 I note that some changes would, nonetheless, be needed in order to comply with the UK government's transposition requirements in relation to the IORP II Directive (and subject always to whatever may emerge from the Brexit process).
- 11.2.3 I have observed some circumstantial evidence that changes in investment policy are decided on and implemented before the statement of investment principles has been revised (on the basis that that is but a relatively low value compliance item to be picked up in due course).
- 11.2.4 By way of explanation of these comments:
- ◆ the trustee board is asked to consider changes to the investment strategy (and such changes are supported by appropriate advice and reports for the trustee board). In other words, the decision making process is properly supported and properly documented, but
 - ◆ the changes should then be transposed into a revision to the statement of investment principles before the change of investment strategy is implemented, and
 - ◆ revision of the statement of investment principles can be seen as delaying the time for execution of the change of investment

strategy with the possible loss of investment return or avoidance of investment risk.

11.2.5 As noted above, the statement of investment principles, and its revision, is seen as relatively low value compliance work which, on one view, could be dealt with after the event while the more important steps of implementing the change of investment policy take place ahead of the revised SIP coming back to the next trustee meeting for approval.

11.2.6 In other words, a combination of:

- ◆ legal risk management (see **B2** above for more detail), and
- ◆ the objective of reducing the frequency of change to a SIP,

both point in the direction of having a general statement that has considerable flexibility within it (and which uses “off the shelf” language).

Philip Bennett

16 July 2018

Annex A

Problems with the analysis supporting on the Law Commission's conclusion on the extent to which trustees may take account of the wishes of scheme members

A. What legal authority did the Law Commission rely on to reach its conclusion?

1. The Law Commission Report No. 374 "Pension Funds and Social Investment", paragraph 1.6 published on 22nd June, 2018 said:

" 1.6 We found that, although financial return should be the trustees' predominant concern, the law is sufficiently flexible to allow other, subordinate, concerns to be taken into account in some circumstances. The law permits pension trustees to make investment decisions that are based on non-financial factors (such as environmental and social concerns), provided that :

- (1) *they have good reason to think that scheme members share the concern; and*
- (2) *there is no risk of significant financial detriment to the fund."*

Note 1: This repeats paragraph 6.101 of Report 350 on the Fiduciary Duties of Investment Intermediaries published on 30th June, 2014.

Note 2: In Report 350 The Law Commission defines "non-financial factors" at paragraph 6.33 as follows:

"By "non-financial factors" we mean factors which might influence investment decisions motivated by other (non-financial) concerns such as improving members' quality of life or showing disapproval of certain industries."

2. This is a copy out of the perfectly sensible statement of Sir Donald Nichols V-C in his judgment delivered on 25th October, 1991 in Harries v Church Commissioners in relation to a charity. This statement expressly distinguishes the position of a charity from a pension fund:

*"If that situation confronts trustees of a **charity**, the law does not require them to find an answer to the unanswerable. Trustees may, if they wish, accommodate the views of those who consider that on moral grounds a particular investment would be in conflict with the objects of the charity, so long as the trustees are satisfied that course would not involve a risk of **significant financial detriment**. But when they are not so satisfied trustees should not make investment decisions on the basis of preferring one view of whether on moral grounds in investment conflicts with the objects of the charity over another. This is so even when one view is more widely supported than the other.*

*I have sought above to consider charity trustees' duties in relation to investment as a matter of basic principle. I was referred to no authority bearing directly on these matters. My attention was drawn to Cowan v Scargill [1985] Ch. 270, a case concerning a pension fund. I believe my views accord with those expressed by Sir Robert Megarry V-C. in that case, **bearing in mind he was considering trusts for the provision of financial benefits for individuals. In this case I am concerned with the trusts of charities, whose purposes are multifarious.**"*

(my emphasis)

Note: This case relates to a charity not a pension fund and predates Section 75 of the Pensions Act 1995 and Part 3 of the Pensions Act 2004.

3. In Cowan v Scargill Megarry V-C, in his judgment delivered on 4th April, 1984, said:

*"Third, by way of caveat I should say that I am not asserting that the benefit of the beneficiaries which the trustee must make his paramount concern inevitably and solely means their financial benefit, even if the only object of the trust is to provide financial benefits. If the only **actual or potential beneficiaries of a trust are all adults with very strict views on moral and social matters, condemning all forms of alcohol, tobacco and popular entertainment, as well as armaments, I can well understand that it might not be for the "benefit" of such beneficiaries to know that they are obtaining rather larger financial returns under the trust by reason of investments in those activities than they would have received if the trustees had invested the trust funds in other investments. The beneficiaries might well consider that it was far better to receive less than to receive more money from what they consider to be evil and tainted sources. "Benefit" is a word with***

a very wide meaning, and there are circumstances in which arrangements which work to the financial disadvantage of a beneficiary may yet be for his benefit.....But I would emphasise that such cases are likely to be very rare, and in any case I think that under a trust for the provision of financial benefits the burden would rest, and rest very heavy, on him who asserts that it is for the benefit of the beneficiaries as a whole to receive less by reason of the exclusion of some of the possibly more profitable forms of investment. Plainly the present case is not one of this rare type of case. Subject to such matters, under a trust for the provision of financial benefits, the paramount duty of the trustees is to provide the greatest financial benefits for the present and future beneficiaries.”

4. This judgment predates the Section 75 debt on the employer regime and the Part 3 of the Pensions Act 2004 statutory funding regime when the employer did not foot the bill for the deficit in a DB scheme.
5. It should also be noted that the employer is usually the residual beneficiary, where there is a surplus, in a pension fund (as well as being owed a duty of care by the trustee when investing the assets of the defined benefit pension fund).
6. Unsurprisingly, given the nature and facts of Cowan v Scargill, no reference is made to the position of the employer when formulating the test which is shown in blue above in the extract from the judgment in Cowan v Scargill.
7. There is a different and valid line of argument that certain investments should be excluded if this is inconsistent with the employer's stated objectives - eg a cancer research charity's pension fund would not invest in tobacco shares.
8. But the valid financial reason for that decision is that to invest in tobacco shares creates a reputational risk for the employer and could reduce employer covenant strength in a body that relies on donations. This is perfectly sensibly addressed in the judgment in Harries v the Church Commissioners.

B. Conclusion

1. As may be noted from the 2 extracts quoted in **Section A** above, the Law Commission's conclusion:
 - 1.1 is based on a judgment in a case relation to the investment powers and their exercise of a charity,
 - 1.2 does not reflect the restrictions in the judgment in Cowan v Scargill (with an express acknowledgement by the judge in the Harries case that he was dealing with a charity and not with a pension fund (so the objects were different)),
 - 1.3 does not recognise that Cowan v Scargill took no account of Section 75 of the Pensions Act 1995 and Part 3 of the Pensions Act 2004 which imposed a statutory obligation on an employer to make good the deficit in a defined benefit pension scheme, and
 - 1.4 does not recognise that, once pensions legislation converts a defined benefit pension fund into security for the employer to pay a member's pension, the person directly affected by the success or failure of the investment policy, in the absence of insolvency, is the employer.
2. In the author's view the Law Commission's conclusion quoted at **A1** above of this Annex is, for the reasons noted in **1** above, invalid and unsafe to be relied on when investing the assets of a defined benefit pension scheme.
3. In the author's opinion, the correct view in relation to a money purchase scheme, is that set out in the judgment of Megarry V-C in Section **A3** of this Annex.

4. In practice, it will be impossible to discharge the burden of proof, which Megarry V-C has set out and which is quoted in **A3** of this **Annex A**, in relation to a money purchase pension scheme in the absence of exceptional circumstances.