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By email

Sinead Donnelly and Vicky Bird
Strategy Policy and Analysis Group
Department for Work and Pensions
pensions.fiduciaryduty@dwp.gsi.gov.uk

Our ref CVPS

Dear Ms Donnelly and Ms Bird

Response to Consultation on Clarifying and Strengthening Trustees' Investment Duties

I am responding on behalf of Squire Patton Boggs (UK) LLP to the DWP's consultation on clarifying and strengthening trustees' investment duties.

Squire Patton Boggs is a leading global law firm which has one of the largest and most experienced teams of specialist pension lawyers in the UK. Our clients include a large number of trustees and sponsoring employers of occupational pension schemes of all sizes and types and from all sectors.

We are responding on our own behalf, and have not been asked by our clients to raise any specific points. We also note the feedback provided by our partners Catherine McKenna and Elizabeth Graham in a consultation meeting you held on 28 June 2018 in Leeds.

We have used the same definitions as those used in the consultation document.

Turning to the specific questions set out in the consultation document:
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?**

This timescale seems sensible.

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

Yes.

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?**

Yes, we agree that linking the ESG, including climate change, to the definition of "financially material considerations" is a welcome clarification and provides helpful flexibility. We would prefer to see some additional guidance to clarify the policy intention behind some of the definitions and other phraseology used, particularly in relation to what may be considered "financially material", clarifying that this should clearly be in the opinion of the trustees who should have full discretion to reach their own views as to whether this criteria is met.

(b) **Do the draft Regulations meet the policy intent?**

Yes.

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?**

We have three comments here.

We would differ with the assertion in paragraph 22 that members' views are already "implicitly referred to by the option to have a policy on ethical considerations". There are a number of complexities here and we think that the consultation combines what is currently optional (i.e. a policy on ethical considerations) with the possible expression of members' views. It is of course appropriate for trustees to respond to such views if they are expressed, but that is a very different proposition to either actively seeking them out or being swayed by such views.

Practical issues which are not addressed in the consultation (notwithstanding the commentary in paragraphs 24 to 29) include the following:

- What would be the consequence if trustees made poor investment decisions based on member views?
- Should trustees be exonerated should they adapt their policy to reflect stated member views?
- What are the limits of accountability and reporting to members?

The danger here is that the nuance in the Law Commission's report (that if member views are known on a particular topic they should be taken into account) risks being transposed into a disproportionate change in the law.

First, being bound by a requirement to prepare a statement setting out how trustees will take account of scheme members' views would involve additional and unnecessary work in the context of the running of a pension scheme. If trustees do take account of members' views they would no doubt wish to publicise that information themselves voluntarily. If they choose not to take account of members' views, for whatever reason, stating that fact is likely to prove inflammatory. The DWP has acknowledged that it is the trustees of an occupational pension scheme who bear the responsibility for investing the funds for the benefit of members. Transparency is ordinarily a useful tool, but in this case trustees are likely to come under pressure from members or other interested parties to invest in a particular manner. If trustees are required to publish a statement explaining the extent to which they take account of members' views it is likely that members would infer their views should be incorporated into the investment design. Where members' views are not incorporated into the SIP it is likely to cause unnecessary tensions, IDRP complaints and complaints to the Pensions Ombudsman, which would waste the time and resources of trustees and the schemes that they govern.

Second, the policy intention seems to be wider than that expressed in this consultation question no.3 and that wider intention, which would require trustees to form some opinion on members' views, gives us cause for concern.

Paragraph 24 of the consultation document states that "…it is good practice for trustees to inform the design of investment strategies with an understanding of scheme members' views. This also aids with assessing value for members, which trustees of DC schemes must do." The DWP notes that the Law Commission, in its report, quoted TPR guidance in demonstrating that trustees of DC schemes should know their membership when designing investment strategy.

Proposed new regulation 2(2)(c) of the Occupational Pensions Schemes (Investment) Regulations 2005 ("**Investment Regulations**") would require trustees to:

"*prepare a statement explaining the extent to which* ***the views which, in the reasonable opinion of the trustees, members of the scheme hold*** *(including the views they hold on non-financial matters) will be taken into account in preparing or revising the statement of investment principles.*"

The proposed amendment would put the principles behind TPR's good practice guidance on a statutory footing for both DB and DC schemes. This seems an unduly onerous requirement, particularly in a DB context.

If this is indeed the intention then in order to comply (and demonstrate "reasonableness") trustees are going to have to incur time and costs engaging with members on the subject and devising means of assessing how their own member population can be best analysed. If it is the policy intent that there should be no obligation on the trustees to seek to assess members' views directly by asking or surveying members, it would helpful if this could be stated.

However, we have more fundamental concerns with this approach. There is a fundamental difference between the position of DC and DB members which undermines the proposition that both sets of members have the same legal rights to direct how scheme assets are invested. Neither DB nor DC schemes established under trust give members legal ownership of the assets.

In a DC scheme there is obviously a clearer correlation between Members' interests and the investment options made available to them by the trustees, although this does not extend to the ability to screen individual investments (which would be unworkable). As the Government will know, most DC members in fact select the default option and thus abrogate responsibility at a fund level to the trustees for the selection of their investments.

In a DB scheme there is a long line of legal authority (in both case law and statute) that supports the argument that no-one other than the trustees own the assets. Consider, for example, Re Courage Group's Pension Schemes (1987), National Grid Co plc v Laws (1999) and Wrightson Ltd v Fletcher Challenge Nominees Ltd (2001) which confirm that members have no proprietary rights in pension scheme funds. Under section 34(1) of the Pensions Act 1995, trustees of an occupational pension scheme are given "the same power to make an investment of any kind as if they were absolutely entitled to the assets of the scheme". This principle is also supported by the exclusion from the categories of instruments or rights constituting investments under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001. Article 89(2) expressly excludes "interests under the trusts of an occupational pension scheme" from constituting rights or interests in investments. DB members of course have a legitimate interest in knowing how their schemes' assets are held, but for the purpose of knowing, insofar as it is possible, that the benefits they have earned will be paid, giving members a greater expectation or right would not only be impracticable in an operational sense (adding costs and complexity), but would inevitably lead to employers asking for the same rights to be enshrined in law. Arguably, employers have a much clearer claim to be represented in a balance of cost scheme, but their only right is to be consulted in the trustees' preparation of or changes to the statement of investment principles.

Third, there is the practical issue, particularly in a large pension scheme with many members, that it will be extremely difficult to assess a large number of members' views, either directly or indirectly, where those views could be very disparate, or influenced by a small majority. Nor could trustees be expected to make assumptions about how members might wish them to invest scheme

funds. In such a situation it is difficult to see how the assessment should realistically influence trustees' investment decision-making for the scheme as a whole.

(b) **Do the draft Regulations meet the policy intent?**

Subject to our comments above, assuming that the policy intent is that set out more fully in the consultation document (rather than in this consultation question) and that it is to require trustees to (1) establish a reasonable opinion as to members' views and then (2) state whether or not they intend to act on them, we agree that the draft Regulations meet the policy intent. If, however, the intention is that trustees should not have to engage directly with members when establishing this view then either guidance or the proposed legislation needs to make this clear.

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 your proposal and that inclusion of the social impact of a particular investment for a pension scheme should remain a matter of choice for trustees as set out in paragraph 50.

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 think this is a sensible expansion/clarification of trustees' existing duties.

(b) **Do the draft Regulations meet the policy intent?**

Yes, and is a much better representation of how trustees can demonstrate their obligations to members than the suggested policy shift in question 3.

However, we would query the reality in relation to small schemes whose investment arrangements are almost always structured via pooled funds where the legal reality is that the providers have legal ownership of the assets and there are highly limited opportunities for trustees to influence asset selection in a manner which takes account of social and ethical issues. Such schemes will find difficulty in effective compliance.

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?**

Yes – this would make the SIP a more relevant document and deter "box ticking". We reflect our comments made in our face-to face consultation with you on 28 June that for many schemes, the SIP is reflective "after the event" of evolving investment strategy and is seen as a compliance document, rather than an active "working document" which itself drives forward investment strategy.

(b) **Do the draft Regulations meet the policy intent?**

Yes. We note that the requirements under paragraphs 30(a) and (b) of part 5 of schedule 3 to the Disclosure Regulations (which apply when investments have not been in accordance with the SIP) would remain in respect of relevant schemes that would be required to prepare an implementation report. Is this the intention? We also consider that the draft regulations incorporating this requirement are overly complex and could more clearly reflect the policy intention.

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 benefit statement.**

(a) **Do you agree with the policy proposal?**

We have no difficulty, of course, with trustees publishing the SIP online if they choose to, but we would counsel against making this a requirement because of the potential consequences for non-members (to whom the trustees owe no duties in law) to use such data for their own ends.

We believe it is important to retain the distinction between public bodies, such as the administering authorities of the Local Government Pension Scheme, who also are subject to the Freedom of Information Act 2000 and who have accountability (albeit indirectly) to tax payers for stewardship of pension fund investments and private occupational pension schemes. The essence of the latter is that automatic enrolment aside – they are private arrangements for the sponsors' employees and former employees which were established voluntarily (unlike the statutory public sector schemes). We agree that

institutional investors such as trustees have an obligation to invest responsibly, but they do so within a legal framework that should not be converted into some form of general public accountability. Mandatory online disclosure would open up the private nature of the arrangements to pressure groups and activists, which we believe would cause smaller schemes in particular considerable difficulties.

(b) **Do the draft Regulations meet the policy intent?**

Yes, but see our comments above. It is not only members who would be able to express their views.

(Although please note that we think there are a couple of typing errors in new regulation 12(5) of the Disclosure Regulations – the word 'paragraph' should be plural and we think it would be better to use the spelling 'publicly' rather than 'publically'.)

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?**

Please see our comments above, especially in relation to the burdens which would be imposed on schemes (and therefore on business where employers pay such expenses), by the consultation in relation to questions 3 and 7.

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

The proposed amendments to the Statutory Guidance requires relevant schemes that produce a SIP to publish their annual report online, so that it is publicly available and accessible by non-members. This appears to go further than the proposed legislative requirements to publish the SIP, implementation report and statement on members' views. Should publication of the whole of the annual report become a requirement, this would need to be included in the legislative provisions, albeit we do not support such mandatory online publication of the annual report.

We note that TPR guidance states that it is best practice for trustees of default arrangements in DC schemes to state their policies on stewardship. We note that this is not currently required under Regulation 2A of the Investment Regulations and that the DWP has specifically rejected this recommendation from the Law Commission in relation to default arrangements. Do you intend asking TPR to revise its guidance in this regard?

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?**

11 The statutory information required to be included in the annual report is set out in part 5 of schedule 3 to the Disclosure Regulations. Whilst much of the information in paragraph 30 of part 5 reflects information contained in the SIP, there is currently no

statutory requirement for the annual report to include the actual SIP prepared in accordance with regulation 2 of the Investment Regulations. If this is to be a requirement under the Statutory Guidance then we think it should also be a requirement under part 5 of schedule 3 to the Disclosure Regulations.

The revised Statutory Guidance does not make specific reference to publishing the statement of members' views as part of the annual report. Whilst this would occur de facto if the annual report were to be published (which we do not support), it may be worth clarifying this in paragraph 60 where reference is made to the "annual report (inclusive of the SIP and implementation report)".

12 **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?**

The other elements of the SIP are derived in large part from Article 18 of the IORP Directive (2003/41/EL). The principles that underpin scheme investment are set out in Article 18(1). The Government will naturally be considering post-Brexit the application of the IORP II (2016/2341 EU) changes. We note that the consultation does not comment on these developments. It would be helpful for the Government to confirm its intentions in this respect, although we note that there is nothing inconsistent in the recast Article 19 of IORP II that conflicts with the policy aims of the Consultation (noting that Article 19(1)(b) requires IORPs to take "into account the potential long-term impact of investment decisions on environmental, social and governance factors").

Yours sincerely

Clifford Sims
Partner
For Squire Patton Boggs (UK) LLP