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Dear Mr Koufou

Sarasin & Partners' response to the Department of Work and Pensions' *Consultation on changes to the Investment Regulations following the Law Commission's report 'Fiduciary Duties of Investment Intermediaries'*

Thank you for the opportunity to provide our views on the Department of Work and Pensions *Consultation on changes to investment regulation.* Our answers to the consultation's specific questions are set out below, but first we wish to make a broader point about the implementation of the findings of the Law Commission's report on *Fiduciary duties of investment intermediaries*.

It is of course important that the Department of Work and Pensions make sensible regulatory changes to clarify that trustees should require their investment managers to take into account financially material longer term considerations (including environmental, social and corporate governance considerations) in their investment activities. Our own view is that the larger area for concern brought to light by the Law Commission's report is the way the policy-makers will deal with contract-based schemes, to which fiduciary duties do not apply. This consultation will not directly affect contract-based schemes, and it is not clear to us how the changes proposed for the Investment Regulations relating to longer term investment and stewardship will be mirrored in contract-based schemes. As an ever greater proportion of people have contract-based schemes,[1] this distinction becomes crucial. While it is too early to tell how the actual workings of independent governance committees will play out, the Financial Conduct Authority's *Final rules for independent governance committees* (February 2015) stress that the primary role of these committees is to assess value for money. Is there a risk, for example, that stewardship by active managers will be seen as non-cost effective, since the economic improvements related to

[1] The total number of active members of contract-based pension schemes was roughly 2,700,000 at the end of 2013 (compared with roughly 3,300,000 in trust-based pension funds). The Pensions Regulator: http://www.thepensionsregulator.gov.uk/doc-library/dc-trust-a-presentation-of-scheme-return-data-2014.aspx#s12023.

stewardship are difficult to attribute, and apply over the longer term? We risk creating a two-tier system under which two types of pension (contract-based versus trust-based) are meant to achieve the same thing – a reliable income in retirement – but are overseen by bodies with different objectives. We understand that the Financial Conduct Authority is reluctant to be overly prescriptive in its rules, and that at a minimum Independent Governance Committees are expected to ensure that default investment strategies are designed in the interests of scheme members, and to provide a clear statement of the aims, objectives and structure appropriate for scheme members. We hope that this will be enough to ensure that the level of care and oversight at contract-based schemes is equivalent to that at trust-based schemes.

In this light, we would like to set out some historical context – you are no doubt familiar with this backdrop, but we feel it is important to bear in mind when considering that the objectives of this consultation should be just as relevant to people with contract-based pensions as to beneficiaries of trust-based pensions. There are fundamental differences between trust law and contract law that could have a significant impact on beneficiary and member interests. The principles that underlie trust law derive from conscience-oriented equity. Equity is a branch of law that was created to address perceived injustice in the common law in the Middle Ages – where the common law did not provide a just solution to a problem, the chancery courts could step in. The spirit of equity is captured by traditional equitable maxims, such as 'equity will not suffer a wrong to be without a remedy' and 'equity delights to do justice and not by halves.'

These imply intent by the court to go out of its way to help those it sees as suffering an injustice. The area of fiduciary duty, in particular, is premised on protecting the interests of vulnerable parties when others make decisions on their behalf. Those beneficiaries who are members of a trust-based pension fund are afforded a high level of legal protection, with courts predisposed to protect their interests.

By contrast, contract law as a general rule assumes that parties to a contract begin on equal footing. The law of contract is underlined by the idea that commercial certainty is best achieved by courts refraining from intervening in arm's length agreements between people. Hence the catch-cry of contract law: *caveat emptor* – buyer beware. The Kay Review argued that '*caveat emptor* is not a concept compatible with an equity investment chain based on trust and stewardship.' We agree – and there could not be a starker contrast between this phrase and the equitable maxims set out above.

Moreover, since the employer is not normally a party to the contract, it owes no duty to the pension scheme member with respect to the scheme. The Pensions Regulator argues that the employer has 'an interest in the efficient running of the scheme.' But neither the employer nor trustees formally represent the interest of members in contract-based pension schemes.

In addition to the gulf between the philosophical underpinnings of contract and equity is a difference related to cold hard cash. Contract remedies are sparing, to encourage economic efficiency. By contrast, equity provides a much wider range of remedies than contract, and English courts have traditionally been generous in compensating those who suffer as a result of breach of fiduciary obligation. To reiterate, contract and trust are two different bodies of law created for different – almost opposing – purposes. In our view, we cannot be satisfied that commercial interests are enough to ensure that members of contract-based pension schemes are provided with appropriate protections given the risks that they bear.

As this consultation does not relate to contract-based schemes, we have provided broad historical context rather than delving into the relative merits of legal protections that do exist for contract-based scheme members. We welcome the further consultation on the legal protections afforded to members of contract-based schemes that the Financial Conduct Authority says is planned for 2017. We believe that it will be vital at that time for the Department of Work and Pensions to ensure that a two-tier pension system is not developing, and that the protections for those people with contract-based pension schemes are equivalent to those with trust-based funds. Finally, we draw your attention to a paper by a member of our team that looks in depth at relevant historical context in this area: Claire Molinari, 'The Future of Fiduciary Obligation for Institutional Investors', in Hawley et al. (eds), *Cambridge Handbook of Institutional Investment and Fiduciary Duty* (2014).

Answers to consultation Questions

Question 1 How could regulation 2(3)(b) of the Investment Regulations be amended so that it more clearly reflects the distinction between financial and non-financial factors?

Answer:

The **existing language** of Regulation 2(3) of the Investment Regulations requires the Statement of investment principles to cover amongst other things "the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments".

Our suggested language is:

> A statement of investment principles must be in writing and must cover at least the following matters… [trustees'] policies in relation to
>
> (vi) How longer term financial considerations are taken into account in the selection, retention and realisation of investments. Longer term considerations should include financially material environmental, social or corporate governance issues.
>
> (vii) The extent to which (if at all) non-financial considerations are taken into account in the selection of investments (for example through the exclusion of certain controversial products or corporate practices, or the preference for certain socially positive corporate practices), where
>
> - Trustees have good reason to think that scheme members would share their judgement; and
> - The decision to exclude or prefer an investment on a non-financial basis does not involve a risk of significant financial detriment to the fund.

Our concerns

It is our understanding that the existing language of Regulation 2(3)(vi) has had little if any effect on institutional investment, and in particular has not promoted a longer term approach to investment. There are several potential reasons for this. First, the clause is optional ("if at all"), so many trustees simply ignore it. Second, the clause appears to imply that social and environmental issues may be ignored in the investment process, even if they are financially material. Third, trustees very rarely make day-to-day investment decisions: this role is delegated to investment managers. While our suggested language addresses these first two points, the third is harder to address.

The requirement that trustees cover "how longer term financial considerations are taken into account" (our suggested language) becomes largely meaningless unless there is a mechanism for ensuring that any policies included in the SIP are implemented by investment managers. Perhaps this could be improved by changing the language slightly as follows:

> A statement of investment principles must be in writing and must cover at least the following matters... [trustees'] policies in relation to
>
> (vi) How investment managers are instructed to take longer term financial considerations into account in the selection, retention and realisation of investments. Longer term considerations should include financially material environmental, social or corporate governance issues.

Or there could be a separate clause that states something like: where day-to-day management of the fund is performed by professional investment managers, trustees must have a policy in relation to how investment managers implement the SIP.

Question 2 - Do you agree that amending the Investment Regulations to require trustees to comply with the current requirements in the Stewardship Code or explain why they have not done so is the most appropriate way to implement the Law Commission's recommendation?

If not, what approach would be more appropriate to encourage trustees to consider their approach to stewardship?

Answer:

No, this is not the correct approach. Commitment to the Stewardship Code is not appropriate for trustees unless they are making day-to-day investment decisions. This is because the code has specific, investment-related requirements:

Amongst other things, signatories to the Code should:

- monitor their investee companies;
- establish clear guidelines on when and how they will escalate their stewardship activities;
- be willing to act collectively with other investors where appropriate;
- report periodically on their stewardship and voting activities.

Many of these requirements are nonsensical for trustees who are not involved in investment activities. Where investment activities are delegated to investment managers, any stewardship activities must be also be carried out by those managers.

A more appropriate approach might be to change the Investment Regulations so that the SIP requires trustees to:

- state their policy on how they require investment managers to report on their commitment to the Stewardship Code; or
- state their policy on whether they require investment managers to comply with the Stewardship Code, or explain why they do not.

Investment consultants can exert a large degree of influence over trustees, particularly those who are less sophisticated. The Department of Work and Pensions should ensure that investment consultants are giving clients accurate, up-to-date information on both Investment Regulation 2(3) and on the Stewardship Code.

Question 3 What steps would trustees need to take to comply with any amendments to the Investment Regulations, as set out in Chapter 2?

What, if any, costs would be involved in meeting any new requirements?

Answer:

We do not wish to respond to Question 3 as others are better placed to express a view.

Thank you for considering our response.

Yours sincerely

Henry Boucher
Partner, Deputy CIO