

Response to DWP ClientEarth Consultation on Changes to the Investment Regulations

April 2015

Background

1. The Law Commission published a report in July 2014 which sought to clarify the fiduciary duties of investment intermediaries ("the Law Commission Report"), focusing in particular on the question of long-term investment by pension fund trustees. The report made the following key findings:
 - Pension fund trustees *should* consider material financial risk when making investment choices. The law is not prescriptive in this regard; trustees must exercise discretion, based on proper advice, to determine which risks are financially material.
 - Pension fund trustees *may* take into account *any* financial factor that is of relevance to the performance of an investment. Such factors may be of an ethical, environmental, social or governance ("ESG") nature.
 - Pension fund trustees *may* consider non-financial factors when making investment choices, so long as (1) they have good reason to think that members would share the concern and (2) there is no risk of significant financial detriment to the fund.
 - Pension fund trustees are not required to maximise returns in the short-term at the expense of risks over the long-term. Indeed, they are required to balance returns against risk. This means risk is just as much a concern for trustees as returns.
2. Against this context, the Law Commission invited the Government to review three elements of the Occupational Pension Scheme (Investment) Regulations 2005 (the "Investment Regulations") in order to ensure that pension fund trustees properly understand and exercise their investment duties on behalf of members and beneficiaries. Specifically, the Law Commission recommended that the Government review whether:
 - (a) schemes with fewer than 100 members should be exempt from regulation 4 of the Investment Regulations, which sets out what trustees are required to consider when making investment decisions;

(b) reference to "social, environmental or ethical considerations" in regulation 2(3)(b) of the Investment Regulations (in the context of the trustee's duty to set out his/her investment policies in a statement of investment principles) should be amended to better reflect a clear distinction between financial and non-financial factors; and

(c) trustees should be required to state their policy (if any) on stewardship.

3. The Department for Work and Pensions ("DWP") has not sought to consult on (a) above since many of the elements of regulation 4 are already being applied by trustees of schemes with less than 100 members. DWP's consultation therefore focuses on (b) and (c), and to this extent, invites responses to the following specific questions:

(i) 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?

(ii) 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?

(iii) What steps would trustees need to take to comply with any amendments to the Investment Regulations, as set out in (i) and (ii) above? What, if any, costs would be involved in meeting any new requirements?

ClientEarth's response to the first question

4. ClientEarth agrees with the Law Commission's view that, in its current form, regulation 2(3)(b) is unhelpful for trustees since the terms "social, environmental or ethical" are not defined in law and provide little in the way of guidance to trustees when making investment choices. The wording also suggests that there may be scope for trustees not to consider what weight to attach, if any, to ethical and ESG factors, which is at odds with the findings of the Law Commission's Report. In the paragraphs that follow, ClientEarth seeks to provide recommendations on amending regulation 2(3)(b) to better reflect a distinction between financial and non-financial factors.

5. Regulation 2(3) currently states:

A statement of investment principles must be in writing and must cover at least the following matters –

(a) the trustees' policy for securing compliance with the requirements of section 36 of the [Pensions Act 1995] (choosing investments);

(b) their policies in relation to –

- (i) the kinds of investments to be held;
 - (ii) the balance between different kinds of investments;
 - (iii) risks, including the ways in which risks are to be measured and managed;
 - (iv) the expected returns of investments;
 - (v) the realisation of investments; and
 - (vi) the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments; and
- (c) their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to the investments.

6. ClientEarth takes the view that a clear distinction can be drawn between financial and non-financial factors if the modifications set out below (in bold and underlined) are made to the regulation. Furthermore, since the primary objective behind the trustees' investment strategy is "to secure the best realistic return over the *long-term*, given the need to control for risks",¹ it is our view that this should also be reflected in the regulation. In this regard, our suggested amendments to regulation 2(3) are as follows:

A statement of investment principles must be in writing and must cover at least the following matters –

- (a) the trustees' policy for securing compliance with the requirements of section 36 of the [Pensions Act 1995] (choosing investments);
- (b) their policies in relation to –
 - (i) the kinds of investments to be held;
 - (ii) the balance between different kinds of investments;
 - (iii) **financial** risks, including the ways in which **such** risks are to be measured and managed;
 - (iv) the expected **long-term risk-adjusted** returns of investments;
 - (v) the realisation of investments; and

¹ Law Commission Report, at paras. 5.56, 6.23, and 7.5. [Emphasis added.]

(vi) the extent (if at all) to which ~~social, environmental or ethical~~ **non-financial** considerations are taken into account in the selection, retention and realisation of investments; and

(c) their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to the investments.

7. We propose that the definitions given by the Law Commission to the terms "financial" and "non-financial" should be integrated expressly in regulation 1(2) (Citation, commencement and interpretation) of the Investment Regulations. Specifically, the Law Commission identified "financial factors" to "mean any factor which is relevant to trustees' primary investment duty of balancing returns against risks"², including ESG factors, and "non-financial factors" to mean factors which might influence investment decisions motivated by non-financial concerns, such as improving members' quality of life.³ We would go even further and state that non-financial factors may include the social and ethical views of members and beneficiaries, the impact of any exercise of investment powers or discretion on communities and the environment, and the impact of any such exercise on the financial system and the economy as a whole. Consequently, the following definitions should be inserted into regulation 1(2):

(2) In these Regulations –

...

"financial" means any factor which is relevant to trustees' primary investment duty of balancing returns against risk, including the financial implications of environmental, social and governance factors;

...

"non-financial" means any factor which might influence investment decisions motivated by non-financial concerns, including (but not limited to): (a) improving members' and beneficiaries' quality of life; (b) the social and ethical views of members and beneficiaries; (c) the impact of any exercise of investment powers or discretion on communities and the environment; and (d) the impact of any such exercise on the financial system and the economy as a whole;

...

8. The inclusion of these definitions would provide further clarity and direction to trustees as to what they should/may consider when making investment decisions without being overly prescriptive. This does not change the *status quo* regarding the wide investment discretion enjoyed by trustees; it simply provides much-needed clarification.

² Law Commission Report, at para. 6.24.

³ Law Commission Report, at para. 6.33.

9. By separating out "social, environmental or ethical considerations", regulation 2(3) has the unintended consequence of polarising financial risk on the one hand and ethical and ESG considerations on the other. ClientEarth and many organisations are aware that factors often labelled as "ESG" can and often do have financial implications on investment performance. For example, climate change has historically been categorised exclusively as an environmental concern but there is now a large body of evidence to suggest that climate change also poses material financial risks to institutional investors, including pension funds. It is hoped, therefore, that by providing a definition of "financial factor" that includes a reference to "ESG factors", the polarisation effect will soon wane and disappear, and that factors such as climate change will, as a matter of logic, be deemed financially relevant by pensions fund trustees.

ClientEarth's response to the second question

10. ClientEarth does not propose to provide a detailed response to the second consultation question regarding the Stewardship Code. We simply note that stewardship should not be treated as separate and distinct from the pension fund trustees' investment responsibilities. Indeed, the two very much run alongside one another.
11. ClientEarth also does not propose to provide a response to the third question regarding the practicalities of implementing the first and second questions.
12. Please do not hesitate to contact Elspeth Owens (Barrister) (eowens@clientearth.org) or Natalie Smith (Lawyer – Canadian qualified) (nsmith@clientearth.org) to further discuss the points raised in this response.

ClientEarth is a non-profit environmental law organisation based in London, Brussels and Warsaw. We are activist lawyers working at the interface of law, science and policy. Using the power of the law, we develop legal strategies and tools to address major environmental issues.

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