

**Association of Pension Lawyers
Investment & DC Sub-Committee**

Trustees taking into account non-financial factors when making investment decisions

The APL has recently seen a number of comments in both the media and in the wider pensions industry that, in our opinion, incorrectly set out the law dealing with the ability of trustees of pension schemes to take into account non-financial factors when making investment decisions. While this should not be taken as legal advice, or relied upon, the APL thought it would be helpful to set out a summary of its understanding of the law as it stands in June 2020.

- Trustees should exercise their powers for the proper purpose of a trust (see *MNRPF*), and Local Authorities have similar fiduciary duties in relation to the LGPS – in relation to pension scheme investment this usually means acting in the beneficiaries’ best financial interests (see *Cowan v Scargill*). The meaning of best financial interests is open to some interpretation (and when forming a judgment on whether it meets that criteria, the impact of a decision can be looked at over different timeframes). Trustees also need to consider their fiduciary duty of prudence when investing (*Re Whiteley*).
- For a DB scheme that means looking to meet the DB promise, and for DC members allowing them to accumulate an adequate pot of cash at retirement (so, both a suitable default and a range of options that can achieve this goal – but see below on self-select).
- Trustees also need to follow a legally ‘proper’ decision-making process, and to put personal views to one side, when investing.
- As such, ESG factors, if **financially material**, should be considered by trustees (and our view is that has always been the case – even before changes in the Investment Regulations).
 - Though it may be splitting hairs, ‘financially material’ does not mean that it has to generate a financial return. For example, it is clear that risk reduction can be financially material (e.g. hedging can generate a loss, and often does so if the portfolio as a whole is doing well, and is still to our mind an investment). Eliminating some other downside risk is still financially material.
 - Similarly, it is clear that financial materiality is measured on a scheme specific basis – as changes to the Investment Regulations highlight – and is not linked to, say, a short term returns. On that basis a long term reduction of risk could also be acceptable.
- In our view, the better view of the law is that **non-financial factors** can only be taken into account if they do not result in any financial detriment – i.e. essentially a tie breaker between two otherwise (on a financial basis) equal investments. However, that is subject to a number of caveats:
 - If non-financial factors can only be taken into account if they do not result in any financial detriment, that would mean that the Law Commission’s 2 stage test is not a correct statement of the law. In particular, we have difficulty with the limb that

requires “the decision should not involve a risk of **significant** financial detriment to the fund”. That suggests that some detriment is acceptable, and we do not agree that is where the law has reached.

- However, the recent Palestine case (*R (Palestine Solidarity Campaign Ltd and another) v Secretary of State for Housing, Communities and Local Government* [2020] UKSC 16.) on first glance now appears to give some support to the contention that the Law Commission’s 2 stage test is ‘good law’. Nonetheless, we do not believe that the case is definitive in this regard (at least in so far as an occupational pension scheme is concerned). Notably, the case was dealing with LGPS investments and the role of guidance given by the Secretary of State to administering authorities, rather than being directed at the trustees of occupational pension schemes. Furthermore, the support given by both the majority and minority in that decision does not fit well with the wording of the Law Commission’s 2 stage test: In *Palestine*, Lord Carnwath articulates the test as “...not involve **significant risk of financial detriment**”, while the Law Commission’s test is “...not involve a risk of **significant financial detriment**”. In our view, these are different tests. As such, although the law may be moving, we are still of the opinion that trustees of occupational pension schemes should approach non-financial factors with caution, and be wary of relying on the Law Commission’s test as authority for taking them into account as a relevant factor in their decision making.
- However, whichever formulation of the legal test you take, the practical significance of this exception is, in our view, virtually non-existent. If you accept either the Law Commission statement, or the slight rewording of it in *Palestine*, then (a) trustees need to be satisfied that there is no risk of a significant financial detriment (or that there is no significant risk of any financial detriment) and (b) that there is good reason to believe that the members would support the approach (which, per *Scargill*, to us effectively means all the members - not even a substantial majority would do). This is a significant, and most probably insurmountable, hurdle to jump for most pension schemes.
- Furthermore, as a trustee’s duty is to exercise its powers for the proper purpose of a trust, it is challenging to see that those powers and duties could be discharged by seeking lay member support for a decision (if indeed that could be obtained) that would otherwise fall short of meeting the core obligations placed on fiduciaries particularly when, for DB schemes and the LGPS, it is not members that underwrite the risk of underfunding.
- In practice, though, we think many factors identified as ‘non-financial’ do, when analysed properly, have a financial impact (notably through a reduction in risk) and therefore might still be characterised as a financially-material factor.
- Clearly, a DC self-select fund, if properly communicated, has more flexibility in this regard – but nonetheless it is incumbent on trustees to ensure that they select the options available to members with regard to the ‘proper purpose’ of that selection power.
- Trustees also need to be aware of the ancillary law. For example:

- The need to obtain proper investment advice/delegate (with the liability protections that can bring) and avoiding coming into the FSMA perimeter. They should also seek legal advice in this complicated area as well.
- The scope of their investment power under their scheme's governing provisions, and statutory investment criteria in the Investment Regulations as applicable (including to invest in the best interests of members and beneficiaries (excluding the employer), and solely in their interests in the event of a conflict).
- The expanding disclosure requirements, which do not fit well (and in some cases cause confusion) with the position on non-financial factors set out above.
- The potential need to consult with the sponsoring employer on changes to the Statement of Investment Principles.

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Webinar on behalf of the Association of Pension Lawyers Investment
and DC Sub Committee

**Trustees' ability to take into account non-financial factors when
investing: has the Supreme Court decision in Palestine changed
anything?**

Rebecca McKay and Jonathan Gilmour

30 September 2020

Introduction

- Thorny and long standing question of whether trustees can take into account non-financial factors when investing
- What are non-financial factors?
 - *“Factors which might influence investment decisions motivated by non-financial concerns such as improving members’ quality of life or showing disapproval of certain industries”* Law Commission Report 2014
- Increasing focus on this question by trustee boards in recent years

Introduction

- Important for trustees to understand their legal duties
- Focusing on obligations on trustees of occupational pension schemes

Case study poll to get started....

The investment consultants to the XYZ Pension Scheme come to a board meeting and tell the XYZ Trustee that they ought to diversify their investment portfolio to include some ESG-related investments because (i) the board has yet to engage with ESG, (ii) it would be doing good if such an investment were made, and (iii) it aligns with the employer's view of what the scheme ought to be doing. They propose that the XYZ Trustee disinvests from a well-performing fund in favour of an ESG fund.

How should the XYZ Trustee approach this scenario?

Trustees' investment duties

- Three key sources
 - Trust deed and rules
 - Case law
 - Legislation



Cowan v Scargill [1985]

- Trustees must act in beneficiaries' "best interests" and it is a paramount duty (para 41)
- When purpose of trust is to provide financial benefits, the best interests are "*normally... best financial interests*"
- So investment power must be exercised to yield "*the best return... judged in relation to the risks of the investment*"
- But.....
 - Best interests does not inevitably and solely mean financial benefit
 - "Benefit" is a word with a very wide meaning

Cowan v Scargill continued

- *“Thus if the beneficiaries are all adults with very strict views on moral and social matters...it might not be for the “benefit” of such individuals to know they are obtaining rather larger financial returns...by way of investment in those activities than they would have received if the trustees had invested...in other investments” (para 56)*
- Such cases likely to be “*very rare*”
- Burden would rest heavily on a pension scheme trustee to assert it is for the benefit of the beneficiaries as a whole to receive less

Merchant Navy Ratings Pension Fund Trustees Ltd v Stena Line Ltd and others [2015]

- Develops concept of best interests duty (para 228/229)
 - Not a paramount stand-alone duty
 - Part of the proper purposes principle
- First look at purpose of trust and benefits intended
- Then consider if proposed action is for the benefit of the beneficiaries or in their best interests
- What is the purpose?
 - For DB schemes, to meet the DB promise
 - For DC schemes, to allow members to accumulate an adequate pot at retirement through a default fund and range of investment options

Where does that leave us?

- As the purpose of pensions schemes is to provide financial benefits, trustees should exercise the investment power taking into account financial factors
- In addition, trustees should
 - Act prudently (including seeking advice)
 - Put aside their personal views
 - Exercise their discretion properly (i.e take into account relevant factors only etc)
- Conclusion - difficult for trustees to invest on the basis of non-financial factors



R (Palestine Solidarity Campaign Ltd and another) v Secretary of State [2020] UKSC 16

- Concerns “ethical” investment in local government pension schemes
- Supreme Court decision
- Regulation 7 of LGPS (Management and Investment of Funds) Regulations (SI 2016/946) requires
 - Investment strategy to be in accordance with government guidance
 - Investment strategy to include policy on how social, environmental and corporate governance considerations are taken into account when investing

R (Palestine Solidarity Campaign Ltd and another) v Secretary of State [2020]

- Government issued “Guidance on Preparing and Maintaining an Investment Strategy Statement” (2016)
- Investment on basis of non-financial factors is permissible in certain circumstances but....
 - *Using pension policies to pursue boycotts, divestments 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*
 - *Administering authorities should not pursue policies that are contrary to UK foreign policy or UK defence policy*

R (Palestine Solidarity Campaign Ltd and another) v Secretary of State [2020]

- Appellants challenged lawfulness of restrictions
- Supreme Court looked at Parliament's purpose in conferring a power to issue the Guidance and "quasi-trustees" status of administering authorities
- Majority view held
 - Purpose was to give guidance on "administration and management" of a scheme
 - Responsibility for investment decisions rests with the administering authorities
- Therefore inclusion of restrictions went beyond powers of Secretary of State and unlawful

R (Palestine Solidarity Campaign Ltd and another) v Secretary of State [2020]

- In reaching its conclusion, the court considered wording in the Guidance re non-financial factors
 - “Schemesmay also take purely non-financial considerations into account provided that doing so would not involve significant risk of financial detriment to the scheme and where they have good reason to think that scheme members would support their decision” (page 9)
- Judgment says wording is adoption, almost word for word, of the Law Commission two-stage test (para 17)

R (Palestine Solidarity Campaign Ltd and another) v Secretary of State [2020]

- Brief reminder...
 - Law Commission 2014 report on Fiduciary Duties of Investment Intermediaries and accompanying guidance on financial and non-financial factors
 - To invest on non-financial grounds
 - Trustees should have good reason to think scheme members would share the concern; and
 - The decision should not involve a risk of significant financial detriment

R (Palestine Solidarity Campaign Ltd and another) v Secretary of State [2020]

- No suggestion that this approach is inappropriate and this wording was not challenged
- Implies investments can be made taking into account non-financial factors if two-stage test met:
 - Lord Carnwath: “*There now seems to be general acceptance that the criteria proposed by the Law Commission are lawful. I agree. Thus administering authorities may take non-financial considerations into account – provided that doing so would not involve significant risk of financial detriment to the scheme and where they have good reason to think that scheme members would support their decision.*” (para 43)

R (Palestine Solidarity Campaign Ltd and another) v Secretary of State [2020]

- Has *Palestine* approved or given credence to the Law Commission test?
- This would be a significant development
- Our view is that, on balance, it has not
 - Case focuses on the legitimacy of provisions in government guidance restricting LGPS investment
 - Not directed at occupational pension schemes
 - No analysis around Law Commission test
 - Different wording compared to Law Commission guidance means it is a different test
- So treat with caution!

Key legislation

- Pensions Act 1995 (sections 33-36)
 - Section 35 – trustees may invest as though “absolutely entitled to the assets”
- Investment Regulations (SI 2005/3378)
 - Regulation 4 - various restrictions on how discretion to invest must be exercised
- Does not permit investment taking into account non-financial factors

Recent & proposed changes to legislation

- Significant recent changes since October 2019
 - SIP must cover trustees' policies on “financially material considerations” and the extent (if at all) “non-financial matters” are taken into account
 - New stewardship obligations
 - Additional disclosure requirements including publication of Implementation Statements
 - Trustee to establish effective system of governance including internal controls (section 249A PA04)

Recent & proposed changes to legislation

- Changes target governance and disclosure
- They direct how trustees should make investment decisions not what investments may be made
 - Having a policy on how non-financial matters are taken into account does not mean trustees may, legally, invest for non-financial reasons
 - Equally, having a policy on financially material considerations has not changed the legal position - trustees have always had to take financial materiality into account (whether ESG related or not)

Recent & proposed changes to legislation

- Pension Schemes Bill - Clause 124 (Climate change risk)
 - New Section 41A PA95 - Regulation making power to impose requirements on trustees of occupational pension schemes to secure effective governance with respect to effects of climate change
 - New Section 41B PA95 – Regulation making power to require disclosure relating to the effects of climate change on the scheme
 - APL received reassurance from DWP that no policy intent to prescribe how trustees should invest....

Recent & proposed changes to legislation

- Pension Schemes Bill – Clause 123 and Schedule 10 (Funding of DB schemes)
 - New sections 221A & 221B PA04 – requirement for a funding and investment strategy (and associated statement) to ensure benefits can be provided over the long term
 - Regulations must ensure “Trustees retain sufficient discretion to be able to comply with their duty to act in the best interests of their beneficiaries.”

Defining “Financially Material”

- Show me the money?! ‘Financially material’ does not mean that it has to generate a financial return.
- Other financial factors may be material to the investment decision: e.g. risk reduction can be financially material, so hedging or the decision to invest in a bulk annuity product could be financially material to the scheme.



Continuing to define “Financially Material”

- The fiduciary duty and exercising powers for their proper purpose.
- Financial materiality is measured on a scheme specific basis:
 - DB or DC? If DC, default fund or self-select fund?
 - The ‘time horizon’ of the scheme?
 - Employer covenant / other funding considerations?
- What risks might apply to the investment now, but also what risks might arise in future?



So what are ‘non-financial factors’?

- Anything that is not financially material? Trustees first will need to do their homework on deciding what financially material factors are.
- *“Factors which might influence investment decisions motivated by non-financial concerns such as improving members’ quality of life or showing disapproval of certain industries”*

Law Commission Report 2014

- Examples include the ethical or moral factors at play when making investment decisions.

Caution with non-financial factors

- But be careful! Just because an investment can be seen as ethical from one perspective does not mean that the investment was made on the basis of that non-financial factor.
- Many factors identified as ‘non-financial’, when analysed properly, do have a financial impact (notably through a reduction in risk) and therefore might still be characterised as a financially-material factor.
- The time horizon of the scheme and of the investment is a material consideration here. Considering the long-term costs of an investment may be financially material for that scheme.
- A note on scheme governance:
 - trustees should remember to consider relevant factors and disregard irrelevant factors
 - trustees should take investment advice
 - trustees should minute decision-making

What if it really is a non-financial consideration leading me to invest?

- It gets tricky...
- Investment Regulations?
- The Law Commission 2-stage test:
 - trustees should have good reason to think that scheme members would share the concern; and
 - the decision should not involve a risk of significant financial detriment to the fund.



Two potential issues with the Law Commission's test

- The fiduciary duty falls on the fiduciary: a trustee's duty is to exercise its powers for the proper purpose of the trust, so how can it exercise those powers by seeking lay member support for a decision that would otherwise fall short of meeting the core obligations placed on fiduciaries?

- Isn't the better view of the law that **non-financial factors** can only be taken into account if they do not result in any financial detriment (i.e. essentially a tie breaker between two investments that are otherwise equal, on a financial basis)?
- Again, often non-financial factors are only one side of the story and the other side might show a financially material factor.

So is the Law Commission formulation open to debate?

- The Law Commission formulation vs. the Supreme Court's iteration of that formulation in the Palestine case:
 - “the decision should not involve a risk of **significant** financial detriment to the fund” (Law Comm)
 - “...not involve **significant risk** of financial detriment” (Supreme Court)
- Keep in mind that the first limb of the Law Commission test comes out of *Harries v Church Commissioners* which dealt specifically with the decision making of charity trustees.
- Difference between the types of factors that could be relevant to charity trustees as opposed to occupational pension scheme trustees?
- Either formulation seems to mean that:
 - trustees need to be satisfied that there is no risk of a significant financial detriment (or that there is no significant risk of any financial detriment); and
 - that there is good reason to believe that the members would support the approach (i.e. all the members - not a substantial majority (see *Cowan v Scargill*)).
- This is a significant, and most probably insurmountable, hurdle to jump for most pension schemes.
- Equally, given that many non-financial factors may in fact be financially material factors in the context of a specific scheme or with further analysis, it is difficult to see why a trustee would take the risk of relying on non-financial factors in their decision-making.

Some other thoughts on using non-financial factors (or not)

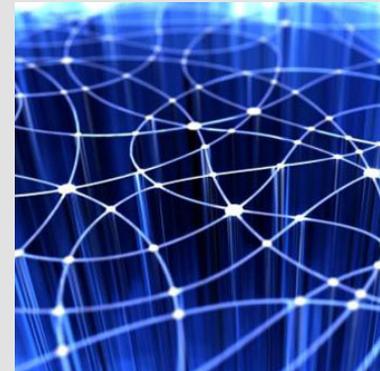
- If the DWP wants to drive a policy towards pension scheme trustees having regard to non-financial factors in pension scheme investing, does it need to change the law? The Investment Regs refer to:
 - *“financially material considerations over the appropriate time horizon of the investments, including how those considerations are taken into account in the selection, retention and realisation of investments”*
 - *“the extent (if at all) to which non-financial matters are taken into account in the selection, retention and realisation of investments”*
- Pension Schemes Bill?
- TCFD reporting consultation?
- Social Market Foundation and others’ call for inclusion of a “social pension fund”, in a similar style to what the French call Solidarity Funds

Member consent – can it override fiduciary duties?

- We have material doubts over whether seeking lay members' consent would discharge trustees' fiduciary duties
- Pension trustees' investment duties are heavily constrained by case law and legislation
- However, position is arguably different for DB schemes & DC default funds compared to DC self select

Member consent – can it override fiduciary duties?

- Other significant hurdles
 - Is it informed consent?
 - From all of the membership?
 - Is the consent valid on an ongoing basis?



Clear as mud: is the discussion of non-financial factors leading to more confusion for trustees?

- Recent changes have given rise to some confusion in the pensions industry over when trustees can take non-financial factors into account. This isn't difficult to see given the last few slides...
- Trustees considering member surveys – may have some limited use in the DC context, but again, how does seeking lay member support for trustee decisions sit against the fiduciary duties of trustees? Is it worth it if you need 100% member support?

Even muddier...

- Threat of climate-related litigation (e.g. the Australian case of *McVeigh v REST*, where initially the claim relied on breaches of the trustee's disclosure obligations, but was widened to include a claim for breach of fiduciary duty).
- Member challenges to the Ombudsman?
- Retrofitting decisions vs. gathering information.

Muddiest?

- The Supreme Court’s decision in the Palestine case has been potentially misrepresented with headlines in the pensions press such as *“Supreme Court overturns govt ban on LGPS ethical investments”* and *“Supreme Court lifts ban on political investments by local council pensions”*
- The PSC response is also unhelpful:
 - *“The Supreme Court has ruled that the Government’s current ban on ethical pensions divestment is unlawful...”*
- Is the recent Palestine case really concerned with whether trustees can base investment decisions on non-financial factors? Arguably not: the decision has limited scope and dealt with whether guidance issued by the Secretary of State could limit a trustee’s ability to exercise its powers in accordance with its fiduciary duties and for the proper purpose of the trust.
- Difference between Secretary of State not being allowed to dictate how LGPS should choose investments vs. LGPS (or trustees of occupational pension schemes) being permitted to make investment choices based on non-financial factors.
- Trustees should be cautious about reliance on the Law Commission’s two-stage test: although the law may be moving, this is still largely untested territory in the occupational pensions arena.

How should Trustees approach the issues?

- Ultimately, trustees need to remember:
 - the need to obtain proper investment advice/delegate (with the liability protections that can bring) and to avoid coming into the FSMA perimeter. They should also seek legal advice in this complicated area!
 - the scope of the investment power under their scheme's governing documents, and statutory investment criteria in the Investment Regulations as applicable (including to invest in the best interests of members and beneficiaries (excluding the employer), and solely in their interests in the event of a conflict)
 - the expanding disclosure requirements, which do not fit well (and in some cases cause confusion) with the position on non-financial factors
 - the potential need to consult with the sponsoring employer on changes to the Statement of Investment Principles

Back to the case study

The investment consultants to the XYZ Pension Scheme come to a board meeting and tell the XYZ Trustee that they ought to diversify their investment portfolio to include some ESG-related investments because (i) the board has yet to engage with ESG, (ii) it would be doing good if such an investment were made, and (iii) it aligns with the employer's view of what the scheme ought to be doing. They propose that the XYZ Trustee disinvests from a well-performing fund in favour of an ESG fund.

How should the XYZ Trustee approach this scenario?

Help is at hand

- APL has put together a note of its conclusions which will make its way onto the website
- APL is speaking with various industry bodies to explain the legal position and its conclusions on non-financial factors.

