SQUIRE PATTON BOGGS

Trustees' Investment Duties – Part 2
Recommended Actions

July 2019

In recent years, the government has commissioned various reports to identify any obstacles that would prevent pension trustees from taking account of environmental, social and governance (ESG) issues as part of their decision-making process, or that would prevent trustees from investing in social impact investments such as the construction of schools and hospitals.

The general conclusion has been that there are, in fact, no legal obstacles, but that many trustees believe that taking account of ESG factors and/or considering social impact investments would run contrary to the long-established principle that trustees must invest in the best financial interests of members.

However, it is now widely accepted that ESG factors are relevant financial considerations, especially when considering the long-term suitability of an investment.

Pensions Minister Guy Opperman said in September 2018:

> **"…if there is confusion that these issues are to do with personal ethics, or optional extras, or can be dealt with through the addition of [an] 'environmentally friendly' chosen fund, then we need to address that misperception [sic] by ensuring that the law is clear."**

Ultimately, it does not necessarily follow that an investment that has a wider social benefit cannot at the same time be a good long-term investment that is consistent with fiduciary duties.

In order to give trustees a gentle nudge, the government amended legislation in the autumn of 2018 to clarify trustees' investment duties in these areas. Trustees must now have a policy in their Statement of Investment Principles (SIP) on financially material considerations (including ESG factors). Trustees must expand their policy on stewardship. Trustees also need to state the extent to which (if at all) non-financial matters, such as members' views on social impact investments, are taken into account.

Additional requirements were introduced for schemes that provide defined contribution (DC) benefits (other than purely additional voluntary contributions [AVCs]). Most of this legislation is effective from 1 October 2019. However, additional changes were also made in June 2019, in order to give effect to the EU Shareholders' Rights Directive II, which had to be implemented into UK law by 10 June 2019. The latest set of amendments introduce additional transparency requirements, including new disclosure requirements for schemes providing defined benefit (DB) benefits. Further information, including relevant deadlines for compliance, can be found in our communication here.

Top Six Actions Trustees Need to Take Now

Prepare a Policy in Relation to Financially Material Considerations	**Review and Revise the Scheme's SIP and Any Default Fund SIP**
Prepare a Policy in Relation to Non-Financial Matters	**Facilitate Publication of Information**
Revise Trustees' Policy on Stewardship	**Monitor Performance Against the SIP**

1. Prepare a Policy in Relation to Financially Material Considerations

Trustees need to put in place (or review, if they already have one) in conjunction with their investment advisers a policy in respect of financially material considerations and, in particular, ensure that the policy includes consideration of ESG factors. This policy will need to be stated in their SIP.

This could mean not only taking "negative" action (such as identifying and refraining from investing in particular areas), but also proactively considering the long-term opportunities presented by certain areas, such as renewable energy.

ESG is becoming more of a topical/political issue, especially in connection with pension schemes. Activist groups such as Extinction Rebellion have gained momentum, even disrupting a PLSA local authority conference and local government pension committee meeting to lobby against continued investment policies by pension schemes in fossil fuels and fracking. While trustees may feel that they should not disinvest from a particular product/industry simply because it is unpopular with a section of society (which may or may not include their members), recent campaigning activity raises further awareness of the long-term viability of certain types of investments, which trustees should, of course, be considering. This comes at a time when The Pensions Regulator (TPR) expects trustees to be setting strategies that take account of long-term financial sustainability of investments.

The latest version of TPR's investment governance guidance for DC schemes has been updated, with expanded sections on sustainability, taking account of financial and non-financial factors, taking account of members' views, stewardship, social impact investing and patient capital. One of TPR's key messages is that ESG is a core financial risk, which trustees will need to consider when setting their investment strategy.

It is also worth noting that, as part of regulations that came into force on 13 January 2019 (which implemented IORP II), TPR is required to issue a code of practice (expected later in 2019) setting out how trustees can discharge their duty to operate an effective system of governance. One of the items, which the code of practice must cover, is how scheme governance arrangements include consideration of environmental, social and governance factors related to investment assets in investment decisions.

Because it is a formal requirement to consult with the employer on the SIP, trustees should be prepared to discuss their proposed policy with the scheme's employer(s) and consider its views.

2. Prepare a Policy in Relation to Non-Financial Matters

Trustees should formulate a policy on the extent (if at all) to which non-financial matters are taken into account when choosing suitable investments. We suspect that many schemes will simply say that they do not take into account members' views. That is a legitimate policy, but given that the SIP is a disclosable document and will soon become a public document that is searchable by non-members, that position may become less tenable.

Trustees, therefore, need to consider whether they will take account of their members' views, and, if so, how they will do so. There is no legal requirement to do so and, arguably, if trustees have no means of understanding the views of members, perhaps because the membership group represents a diverse range of people, it is unlikely that trustees would be able to do so effectively. On the other hand, in smaller schemes where trustees are familiar with the membership and/or already actively engage with the membership on their views, they might feel that their understanding of members' views is good. In those circumstances, trustees could reasonably decide to take account of members' views, provided that there is no risk of significant financial detriment to the fund. Note, however, that there is no "safe harbour" if trustees take account of members' views – trustees must still be satisfied that the investment is appropriate from a financial perspective.

TPR notes: "The impact of investment decisions is a lesser concern to the primary purpose of pension investing, which is delivering an appropriate return. There is, however, no barrier to investments that have a social impact as a by-product where that primary purpose is met."

Many social impact investments will be illiquid investments, less capable of being realised over the short-term. Trustees must always consider how any such investment would affect the security, quality, liquidity and profitability of the portfolio as a whole. In its DC governance investment guidance, TPR summarises the contents of a Law Commission report into social impact investing, and notes:

"Trustees can also choose to actively take account of impact considerations in making an investment decision where they have good reason to think scheme members share their view and there is no risk of significant financial detriment to the fund. They should not choose impact investments where there is a risk of significant financial detriment to the fund."

This, of course, is easier to achieve and likely to be subject to less criticism within a DC environment, as trustees are able to include a fund that some, if not all, of the members would be interested investing in without reducing other investment options available to members.

3. Revise Trustees' Policy on Stewardship

Trustees should take this opportunity to reconsider how (and/or whether) they consider and monitor the performance, strategy, risks, social and environmental impact, and corporate governance of companies in which scheme funds are invested. Now would be a good time to have a discussion with the scheme's fund managers on their voting policies and practices. The importance of doing so, and the ease with which some trustees are able to do this, has come under scrutiny in a recent review by the Association of Member Nominated Trustees.

4. Review and Revise the Scheme's SIP and Any Default Fund SIP

Each SIP will need to be reviewed and revised before 1 October 2019, even if this is outside the usual three-year cycle. While the policy in relation to arrangements with asset managers does not need to be included in the SIP until 1 October 2020, trustees might find this a good time to consider that also. Trustees will need to consult the employer(s) in relation to the SIP before finalising it.

5. Facilitate Publication of Information

Trustees should investigate how they will make the SIP (and eventually the implementation report) available online in a publicly accessible format. If the pension scheme or the employer does not have a website on which the SIP could be published, it might be that the scheme's consultants or investment manager would be prepared to publish the SIP on their website. This is a pressing issue for trustees of schemes providing DC benefits (excluding where such benefits are AVCs only), as they must publish their SIP in a publicly available format by 1 October 2019.

DC benefit statements should be updated to include a statement that the SIP (and implementation report once it has been prepared) is available online. This should include a note of the website address, where the documents can be found on the website and an explanation of how the documents may be read.

6. Monitor Performance Against the SIP

Not quite as immediate, but once the revised SIP is in place, trustees should put in place an action plan enabling them to monitor performance against the SIP and to produce an implementation report in the scheme's annual report and accounts (which will differ depending upon whether the scheme is pure DB or provides some DC benefits).

There is a lot of planning for trustees to do and the suggested actions are only the most pressing. For example, from 1 October 2020, trustees will need to have in place a policy in relation to any arrangements with asset managers covering how they incentivise and remunerate asset managers and how they monitor portfolio turnover costs and the duration of the agreement. In an ideal world, trustees would also consider the changes required from October 2020 and factor them into the revisions being made to their scheme SIPs this year.

If you wish to discuss any of the issues raised in this communication, please get in touch with your usual firm contact.

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