"IS IT ALWAYS ABOUT THE MONEY?"
Pension trustees' duties when setting an investment strategy:

The Law Commission has been reviewing the fiduciary duties of investment intermediaries. A central concern was the legal duties of pension trustees when they make investment decisions. In particular, how far may (or must) trustees consider interests beyond the maximisation of financial return, such as questions of environmental and social impact, and the ethical views of their beneficiaries? This note is a summary of the Law Commission's guidance.

DUTIES OF PENSION TRUSTEES

The legal duties of pension trustees derive from at least three sources.

- **The trust deed**

This will relate to the purpose of the investment power given and how that power can be used to promote the purpose of the trust.

- **The pensions legislation**

Trustees must act within the confines of the legislation. For example an investment power should be exercised in a manner "calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole"; and scheme assets must be properly diversified to "avoid excessive reliance on any particular asset, issuer or group of undertakings."

- **Judge-made duties**

In particular, trustees should act for the proper purpose; take into account all relevant considerations, and ignore irrelevant ones; take advice; and should act "with such care and skill as is reasonable in the circumstances". Those who act in a professional capacity or who hold themselves out as having special knowledge or experience will be held to a higher standard than lay trustees.

THE PRIMARY PURPOSE OF INVESTMENT POWERS

In pensions, the purpose of the investment power is usually to provide a pension – with contributions invested to provide a return, often several years into the future. The primary aim of an investment strategy is therefore to secure the best realistic return over the long term, given the need to control for risks.

The key distinction is between financial and non-financial factors. Financial factors are any factors which are relevant to trustees' primary investment duty of balancing returns against risks. A non-financial factor is one motivated by other concerns, such as showing disapproval of certain industries.

Trustees may always take account of financial factors. They may also take account of non-financial factors if two tests are met. These are described below.

FINANCIAL FACTORS

Trustees are required to balance returns against risk. This is not a question of maximising returns: risks matter just as much as returns. Not all risks can be quantified. They often involve questions of judgement, which must be assessed at the time of the decision, not in hindsight.

The risks to a company's long-term sustainability

When investing in equities over the long-term, the risks will include risks to the long-term sustainability of a company's performance. These may arise from a wide range of factors, including poor governance or environmental degradation, or the risks to a company's reputation arising from the way it treats its customers, suppliers or employees. A company with a poor safety record, or which makes defective products, or which indulges in sharp practices also faces possible risks of legal or regulatory action.

Where poor business ethics raise questions about a company's long-term sustainability, we would classify them as a financial factor which is relevant to risk.

Trustee *may* take all these factors into account

Trustees *may* take account of any financial factor which is relevant to the performance of an investment. These include risks to a company's long-term sustainability, such as environmental, social or governance factors (often referred to as "ESG" factors).

The Law Commission's conclusion is that there is no impediment to trustees taking account of environmental, social or governance factors where they are, or may be, financially material.

Trustees *should* take financially material factors into account

The law goes further: trustees *should* take account of financially material risks. But the law does not prescribe a particular approach. It is for trustees' discretion, acting on proper advice, to evaluate which risks are material and how to take them into account.

It is not necessarily helpful to say that trustees "must" take an ESG approach. The ESG label is ill-defined: it covers a wide variety of risks, and many different approaches. The fact that a particular factor is conventionally classified as an "ESG" factor will not be conclusive as to whether it is financially material to the particular investment.

Instead the duty may be put in the following terms. When investing in equities over the long-term, trustees should consider, in discussion with their advisers and investment managers, how to assess risks. This includes risks to a company's long-term sustainability.

NON-FINANCIAL FACTORS

"Non-financial factors" are factors which might influence investment decisions that are motivated by other (non-financial) concerns, such as improving members' quality of life or showing disapproval of certain industries.

The distinction between financial and non-financial factors may be illustrated with an example. Withdrawing from tobacco because the risk of litigation makes it a bad long-term investment is based on a financial factor. Withdrawing from tobacco because it is wrong to be associated with a product which kills people is based on a non-financial factor.

In general, non-financial factors may be taken into account if two tests are met:

- 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.

This means that if trustees wish to consider non-financial factors, they should ask two questions.

Question 1: Do we have good reason to think that scheme members share the concern?

Trustees may not impose their own ethical views on their beneficiaries. If trustees wish to take account of a non-financial factor, they must have good reason to think that scheme members would share their concern.

Is survey evidence required?

Not necessarily. In some cases trustees may be able to make assumptions: an example might be activities which contravene international conventions, such as manufacturing cluster bombs. The fact that these are banned by the Convention on Cluster Munitions, ratified by the UK, may give trustees reason to think that most people would consider them to be wrong. When coupled with letters from members agreeing, and no letters disagreeing, trustees would have good reason to think that they were acting on members' concerns rather than their own.

In other cases, it may be necessary to consult members more formally.

Must all members agree?

We do not think that there needs to be 100% agreement. That will usually be unachievable. If a majority are opposed to an investment while the rest remain neutral, that may be enough.

The more difficult question is where a majority think that the disinvestment should take place but a minority disagree strongly. In cases where the issue is clearly controversial, the courts would expect trustees to focus on financial factors rather than becoming embroiled in disagreements between the members.

Do trustees have to consider members' views?

No. Trustees *may* consider the views of the beneficiaries when making their investment decisions, but there is no legal requirement for them to do so. However, they should only take account of non-financial factors if they reflect members' views and interests – rather than the views of the trustees.

Question 2: Does the decision risk significant financial detriment?

If trustees wish to take a decision motivated by non-financial factors, they should seek advice from their financial advisers on the effect of the decision on returns to the fund. They should not proceed if the decision risks significant financial detriment to the fund.

Often excluding a sector of the market will not risk significant detriment. The law does not require a portfolio to be diversified to the fullest extent possible. Instead it is a question of degree. For example, in *Harries*, the Church Commissioners reached the view that excluding 13% of the market would be acceptable, while excluding 37% would not be. The court held that this decision did not err in law. It was the trustees' discretion and the court would not interfere.

However, if trustees are advised that a decision would risk significant financial detriment, they should not normally proceed.

The interaction between the two tests

Any decision made on non-financial grounds is subject to both tests. However, the ultimate decision should be looked at in the round, considering the evidence on both questions.

For example, if trustees are faced with compelling evidence that members feel very strongly about the issue, then they may be justified in accepting a risk of some possible detriment, so long as that detriment is not significant. Conversely, if trustees receive clear professional advice that the decision is financially neutral, with some members agreeing and some indifferent, the trustees may still go ahead. The position may be different where only a modest level of agreement is combined with some risk of detriment.

Exceptions: when can significant financial detriment be justified?

There are two clear exceptions where significant financial detriment is permitted:

- where the decision is expressly permitted by the trust deed; and
- in defined contribution schemes, where the member has chosen to invest in a specific fund.

Different considerations may also apply to “affinity groups”, where members share a particular moral or political viewpoint. Here trustees should still ask the same questions, but the answers may be applied more flexibly. It may be easier to establish a consensus among members.

THE STATEMENT OF INVESTMENT PRINCIPLES (SIP)

Pension trustees are required to prepare a SIP stating their policy on the kinds of investments to be held and the extent (if at all) to which social, environmental or ethical considerations are taken into account when making investment decisions. This does not give trustees any special authority to consider non-financial factors. Any investment strategy in the SIP must accord with the general law

The reference to “social, environmental and ethical issues” may be confusing. It would be preferable to think in terms of financial and non-financial factors.