



Department
for Work &
Pensions

Consultation on changes to the Investment Regulations following the Law Commission's report 'Fiduciary Duties of Investment Intermediaries'

Public Consultation

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Chapter One

Introduction

1. For most people a pension is the most significant long term investment that they make in the financial markets. It is here that individuals most rely on investment intermediaries to look after their interests.
2. Therefore the Government wants to ensure that trustees of pension schemes understand the extent of their investment powers and duties, and that the law supports them in meeting these.
3. This consultation follows recommendations relating to the law governing investments in occupational pension schemes, made by the Law Commission in its report 'Fiduciary Duties of Investment Intermediaries'¹ in July 2014. These recommendations cover two key themes:
 - the difference between financial and non-financial factors when taking decisions about investments; and
 - the role that a 'stewardship' approach can play when taking decisions about investments.
4. The Investment Regulations apply to both defined benefit (DB) and defined contribution (DC) schemes. Therefore any changes to legislation made as a direct result of this consultation will apply to both DB and DC schemes and/or any hybrid permutations of these scheme types. For further details on the relevant pensions legislation please see annex B.

Background

5. In July 2012, Professor John Kay published his report "The Kay Review of UK equity markets and long-term decision making"². This concluded a year-long review, commissioned by the Department for Business Innovation and Skills, considering the functioning of the UK's equity markets.
6. The Kay Review found significant uncertainty throughout the investment chain about the application of the legal concept of fiduciary duties. In particular, it found that some investment intermediaries were interpreting their duties to clients or to beneficiaries to mean the duty to maximise short-term financial returns, thus precluding consideration of factors which could impact on company performance, and therefore on investment performance, over the longer term.
7. The Government subsequently tasked the Law Commission to investigate fiduciary duties, including the extent to which fiduciaries including pension scheme trustees may, or must, consider:

¹ http://lawcommission.justice.gov.uk/publications/fiduciary_duties.htm

² https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf

- factors relevant to long-term investment performance which might not have an immediate financial impact, including questions of sustainability or environmental and social impact;
 - interests beyond the maximisation of financial return; and
 - generally prevailing ethical standards, and / or the ethical views of their beneficiaries, even where this may not be in the immediate financial interest of those beneficiaries.
8. The Law Commission published its final report “Fiduciary Duties of Investment Intermediaries” in July 2014. It concluded that trustees should take into account factors which are financially material to the performance of an investment, including over the long term. Where trustees think ethical or environmental, social or governance (ESG) issues are financially material they should take these into account.
9. The Law Commission also concluded that, while the pursuit of a financial return should be the predominant concern of pension trustees, the law is sufficiently flexible to allow other, non-financial, concerns to be taken into account provided trustees have good reason to think that scheme members share their view, and there is no risk of significant financial detriment to the fund.
10. In October 2014, the Government published its progress report on the implementation of the Kay Review³. In it, the Government welcomed the Law Commission’s conclusions on the consideration of long-term factors, as well as their view that trustees may make investment decisions based on non-financial factors in some circumstances.

The Investment Regulations

11. The Law Commission recommended that the Government should review three aspects of the Occupational Pension Schemes (Investment) Regulations⁴ (“The Investment Regulations”) to ensure these Regulations support trustees in understanding and meeting their duties.
12. In particular, the Law Commission recommended that the Government review:
- (1) the exemption of schemes with fewer than 100 members from the regulation which sets out what trustees are required to do when choosing investments (regulation 7);
 - (2) the reference to “social, environmental or ethical considerations” as one of the matters to be included in the statement of investment principles, to ensure that it accurately reflects the distinction between financial factors and non-financial factors; and
 - (3) whether trustees should be required to state their policy (if any) on stewardship.
13. In the October 2014 progress report, the Government committed to consult in early

³ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf

⁴ S.I.2005/3378

2015 on points (2) and (3) of this recommendation. This consultation fulfils that commitment.

14. Point (1) concerns regulation 4 of the Investment Regulations which sets out what trustees are required to do when choosing investments. Regulation 7 of the investment regulations dis-applies the effect of regulation 4 for schemes with fewer than 100 members. From our discussions with stakeholders, we believe that many of the elements of regulation 4 are in fact already effectively applied by trustees of schemes with less than 100 members, including as a result of general trust law.
15. We are also (subject to parliamentary approval) bringing in new measures from April 2015⁵ to strengthen the governance of occupational workplace pension schemes of all sizes. These new governance measures will drive up standards in schemes of all sizes and include a requirement for trustees to report on the design and performance of their default investment options. We therefore consider that removing the exemption for schemes with fewer than 100 members from regulation 4 at the current time is not necessary.

Guidance

16. The Law Commission also recommended that The Pensions Regulator (TPR) should consider how the Law Commission's guidance on fiduciary duties could be given greater exposure and authority to assist trustees in investment decisions. Following this recommendation, TPR has updated the guidance provided via their Trustee Toolkit to reflect the Law Commission's findings⁶. TPR has also promoted the Law Commission's guidance to their trustee mailing list, as well as via their website.
17. TPR will update its investment guidance in the course of 2015 as part of a review of its DC publications to reflect the introduction of new DC governance and charges requirements, as well as supplementing the Defined Benefit Code of Practice⁷ with more detailed guidance on investment strategy and integrated risk management.

Social investments

18. The Government is keen to encourage the growth of new markets that allow investments to be made on the basis of both financial and social returns. The Cabinet Office is currently working on a number of initiatives designed to grow the supply of and the demand for social investments and create an enabling environment for investors and enterprises. We know that trustees in a number of pension schemes have been seeking to understand to what extent such investments may be consistent with their duties to the scheme.
19. The Law Commission's guidance on the need for trustees to consider any factors, including social factors, in determining what is financially material to the

⁵ <http://www.legislation.gov.uk/ukdsi/2015/9780111128329/contents>

⁶ www.thepensionsregulator.gov.uk

⁷ www.thepensionsregulator.gov.uk/codes/code-funding-defined-benefits.aspx

performance of an investment and on how trustees may make investment decisions based on non-financial factors, provide useful guidance in this context.

What this consultation does

20. This consultation seeks views on potential amendments to the Investment Regulations; set out in Chapter 2. The consultation period will last for 8 weeks ending on 24 April 2015. Once stakeholder views have been taken into account we intend to publish a Government response later in 2015.

Chapter Two

Reference to “social, environmental, or ethical considerations”

Introduction

1. Trustees are required to prepare and maintain a written statement of the investment principles that govern the decisions made on investments by the scheme (a ‘SIP’).
2. The Law Commission found that the wording of the Regulations governing the content of the SIP may not help trustees to understand which factors they should consider in their investment decisions. In particular, the Law Commission suggested that the current requirement referring to “social, environmental or ethical considerations” may be unhelpful, and should be reviewed in the context of helping trustees distinguish between financial and non-financial factors.

The Law Commission’s findings

3. Section 35 of the Pensions Act 1995 requires trustees to prepare and maintain a SIP. Requirements concerning the content and review of SIPs are set out in regulation 2 of the Investment Regulations.
4. The SIP requires trustees to plan how they invest the scheme’s assets, balance the risks of doing so and forecast the expected returns on investment. The trustees or the investment manager must exercise their powers of investment in accordance with the SIP. The scheme’s sponsoring employer has a right to be consulted on the contents but may not dictate the scheme’s investment policy.
5. Regulation 2(3) of the Investment Regulations requires the SIP 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”.
6. The Law Commission found that the terms environmental, “ESG” and “ethical” are not clearly defined in law. They concluded that the current use of these terms is unhelpful for trustees in determining whether or not they should consider particular elements in their investment decisions.
7. The Law Commission report made it clear that trustees should consider those features which are financially material to the performance of an investment. It described these features as any “financial factors” which are relevant to trustees’ primary investment duty of balancing returns against risk. In contrast, it described non-financial factors as those which might influence investment decisions motivated by other concerns such as improving members’ quality of life or showing disapproval of certain industries. The Law Commission confirmed that whether a particular feature is classified as an ESG or ethical factor will not be conclusive as

to whether or not it is financially material.

8. The report separately clarified that trustees may make investment decisions that are based on non-financial factors, provided they have good reason to think that scheme members share their view about these factors, and there is no risk of significant detriment to the fund.
9. The Law Commission recommended that regulation 2(3)(b)(vi) of the Investment Regulations should be amended to distinguish more clearly between financial and non-financial factors. In particular, the Regulations as they stand, imply that there is scope for trustees not to consider what weight, if any, to attach to ESG and ethical factors. This does not appear to be consistent with the Law Commissions' conclusions about trustees' broader legal duties to consider financial factors, regardless of whether these may also be ethical or ESG factors.
10. This consultation therefore seeks views on how the Regulations should be amended in light of the Law Commission's recommendations. In particular we would like respondents' views on whether trustees should be required to state their policy on a) how they evaluate long-term risks, including from ESG and other factors which may be financially material to the performance over their investments; and b) determining whether and in what circumstances it would be appropriate to make investment decisions on the basis of non-financial factors.
11. The Law Commission's report also concluded that it would not be appropriate to attempt to codify the general law of fiduciary duties through legislation. The Government agrees with this conclusion. As the Commission noted, this would be a complex and lengthy process and would risk unintended consequences, in particular undermining the flexibility and adaptability inherent in common law. We do however want to ensure that trustees are empowered to consider a range of factors when formulating their investment strategies, in line with the Law Commission's findings.
12. We would welcome views in particular on whether amendments to regulation 2(3)(b) of the Investment Regulations 2005 could be made in such a way as to provide appropriate clarity for trustees regarding their legal duties on this point.

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?

Stewardship

Introduction

13. Both the Kay Review and the Law Commission commented on the value of investors having meaningful relationships with those they invest with. To support and encourage trustees to consider their approach to stewardship, the Law Commission recommended that the Government should consider requiring trustees to state their policy on stewardship in their statement of investment principles (SIP).
14. Separately from this, some stakeholders have also suggested that trustees should be required to disclose other information about their investment functions such as:
 - the selection, retention and realisation of investments;
 - the exercise of rights;
 - the scheme's engagement with and selection of investment managers; and
 - the selection and monitoring of investment funds.
15. The Government has committed to consulting on these matters later in 2015, as part of a broader package of work on disclosure of costs and charges, and will be seeking views then on the potential benefits of such disclosure; how it could be achieved and what issues, if any, would need to be addressed.

The Law Commission's findings

16. The Kay Review stressed the value of investors having meaningful relationships with companies and this was echoed by the Law Commission, who stated in their report "it is clearly in the interests of pension funds as a whole to do all they can to promote the long-term success of the companies in which they invest".
17. The Law Commission recommended that trustees should be encouraged to consider whether and how to engage with companies to promote their long-term success, either directly or through their investment managers, and recommended including a specific requirement for the SIP to contain a statement of the trustees' policy (if any) on stewardship. The information in this statement should cover, for example, whether trustees intend to engage with companies or exercise voting rights, either directly or through their investment managers, and how this will be undertaken.
18. In the Government's response to the Law Commission's report it committed to consulting on changes to the Investment Regulations to require trustees to state their policy (if any) on stewardship in the SIP. The Government response suggested this should mirror what is set out in the current principles and guidance requiring trustees to report against the Stewardship Code.
19. The effect of this would be a requirement on trustees to state in their SIP:

- that they have signed up to the Stewardship Code, or explain why they considered this was not relevant to them in discharging their investment duties; and
- if they have signed up to the code, how they comply with the principles of the Code, or explain to what extent, and on what grounds their approach departs from these principles.

20. This consultation therefore seeks views on whether the Investment Regulations should be amended to require trustees to state their policy with reference to the Stewardship Code.

Stewardship and the Stewardship Code

21. Stewardship aims to promote the long term success of companies in such a way that the ultimate providers of the capital (scheme members) also prosper. Effective stewardship benefits companies, investors and the economy as a whole.

22. For investors, stewardship activities include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration. Engagement is purposeful dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings.

23. The UK Stewardship Code⁸, first issued in 2010, sets out the principles of effective stewardship by investors. It is directed at two key groups in the investment chain: asset managers; and asset owners (in the case of occupational pensions, trustees of the scheme). The Code assists investors to exercise their stewardship responsibilities. Signatories to the Code are required to state how they implement the seven principles and guidance of the Code, which apply on a 'comply or explain' basis. The Stewardship Code acknowledges that asset owners may outsource to managers day-to-day responsibility for stewardship whilst ensuring that activities are undertaken in a manner consistent with their own approach.

24. Signatories to the Code should:

- publicly disclose their policy on how they will discharge their stewardship responsibilities;
- have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed;
- 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;
- have a clear policy on voting and disclosure of voting activity;
- report periodically on their stewardship and voting activities.

⁸ The Stewardship Code can be found at <https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx>

Consultation questions

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?

Chapter Three

Implementation and next steps

1. This consultation will end on 24 April 2015 and we will publish a Government response later this year. We would expect any changes to secondary legislation resulting from this consultation to be made in 2016.
2. We would be interested in views on the steps trustees would need to take to comply with any changes to the Investment Regulations as described in this consultation, and how long would be needed to implement these.
3. We would also be keen to understand further any costs involved in meeting these new requirements.

Consultation questions

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?

Annex A: How to respond

Introduction

1. This consultation provides an opportunity to seek stakeholder views on our proposals set out in Chapter 2. The consultation period will last for 8 weeks ending on 14 April 2015. Once stakeholder views have been taken into account we intend to publish a Government response later in 2015.
2. Further information and documents relating to the Kay Review of 2008, the Law Commission recommendations following this review and the Government Response can be found on the gov.uk website⁹.
3. The views and comments received in response to this document will be analysed in order to understand the perspective of those who may be affected by any changes to legislation.

About this consultation

Who this consultation is aimed at

4. We welcome comments on the proposals from:
 - pensions industry bodies and professionals;
 - trustees or scheme managers;
 - pension scheme members and beneficiaries;
 - employers and representative organisations; and
 - any other source.

Scope of consultation

5. This consultation applies to England, Wales and Scotland. Northern Ireland has its own body of pension's law and references to Great Britain legislation are to be taken, where necessary, as including references to the corresponding Northern Ireland legislation.

Duration of the consultation

6. The consultation period begins on the 27 February 2015 and will close on the 24 April 2015. Please ensure that your responses reach us by that date as any replies received after this may not be taken into account.

⁹ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/367070/bis-14-1157-implementation-of-the-kay-review-progress-report.pdf

How we consult

Freedom of information

7. The information you send us may need to be passed to colleagues within the Department for Work and Pensions, published in a summary of responses received or referred to in the published consultation report.
8. All information contained in your response, including personal information, may be subject to publication or disclosure if requested under the Freedom of Information Act 2000. By providing personal information for the purposes of the public consultation exercise, it is understood that you consent to its disclosure and publication. If this is not the case, you should limit any personal information provided, or remove it completely. If you want the information in your response to the consultation to be kept confidential, you should explain why as part of your response, although we cannot guarantee to do this.
9. To find out more about the general principles of Freedom of Information and how it is applied within the Department, please contact:

Central Freedom of Information Team
Caxton House
6-12 Tothill Street
London
SW1H 9NA

Email: Freedom-of-information-request@dpw.gsi.gov.uk

10. The Central Freedom of Information team cannot advise on specific consultation exercises, only on Freedom of Information issues. More information about the Freedom of Information Act can be found at www.dpw.gov.uk/freedom-of-information

Consultation principles

11. This consultation is being conducted in line with the new [Cabinet Office Consultation Principles](#). The key principles are:
 - departments will follow a range of timescales rather than defaulting to a 12-week period, particularly where extensive engagement has occurred before;
 - departments will need to give more thought to how they engage and consult with those who are affected;
 - consultation should be 'digital by default', but other forms should be used where these are needed to reach the groups affected by a policy; and
 - the principles of the Compact between government and the voluntary and community sector will continue to be respected.

Feedback on the consultation process

12. We value your feedback on how well we consult. If you have any comments on the process of this consultation (as opposed to the issues raised) please contact our Consultation Coordinator:

Elias Koufou
DWP Consultation Coordinator
2nd Floor
Caxton House
Tothill Street
London
SW1H 9NA

Phone 020 7449 7439

Email: elias.koufou@dwp.gsi.gov.uk

13. In particular, please tell us if you feel that the consultation does not satisfy the consultation criteria. Please also make any suggestions as to how the process of consultation could be improved further.

14. If you have any requirements that we need to meet to enable you to comment, please let us know.

15. We will aim to publish the Government response to the consultation on <http://www.dwp.gov.uk/consultations>

16. The report will summarise the responses.

How to respond to this consultation

17. Please send your consultation responses to:

Email: REINVIGORATING.PENSIONS@DWP.GSI.GOV.UK

18. When responding, please state whether you are doing so as an individual or representing the views of an organisation. If you are responding on behalf of an organisation, please make it clear who the organisation is, and where applicable, how the views of members were assembled. We will acknowledge your response.

Annex B: Relevant pensions legislation

1. The investment decisions of trustees are governed by the Pensions Act 1995, the Pensions Act 2004 and the various regulations made under these Acts.

Investment Powers

2. Section 34 of the Pensions Act 1995 provides occupational pension scheme trustees with a wide investment power. This means that they have the same powers to make an investment as if they were absolutely entitled to the assets of the scheme, including the delegation of decision-making about investments to a fund manager. However this is constrained and is subject to the trust deed and relevant case law.
3. It is also constrained by the Occupational Pensions Schemes (Investment) Regulations 2005. Regulation 4 requires that:
 - the scheme assets are invested in the best interests of members and beneficiaries;
 - the power of investment is exercised in a manner “calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole”;
 - assets held to cover the schemes technical provisions are invested in a manner “appropriate to the nature and duration of the expected further retirement benefits under the scheme”;
 - scheme assets consist predominantly of investments admitted to trading on regulated markets and those which are not, are kept to a prudent level;
 - scheme assets must be properly diversified to “avoid excessive reliance on any particular asset, issuer or group of undertakings and so as to avoid accumulations of risk in the portfolio as a whole”;
 - investments in derivative instruments may only be made in so far as they contribute to a reduction of risks or facilitate efficient portfolio management.
4. Regulation 4 of the Investment Regulations implements article 18(1) of the Institution for Occupational Retirement Provision (IORP) Directive (2003/41/EC).
5. Schemes with fewer than 100 members are excluded for the requirements of regulation 4 of the Investment regulations. Under regulation 4 trustees of schemes with fewer than 100 members have a more limited duty to have regard to the need for diversification of investments, in so far as appropriate to the circumstances of the scheme.
6. Section 34(2) of Pensions Act 1995 provides that any decision about investments may be delegated by or on behalf of the trustees to an investment manager authorised by the Financial Conduct Authority.
7. Under section 47(2) of the Pensions Act 1995 where an occupational pension scheme has assets which consists of or includes investments an investment manager must be appointed by or on behalf of the trustees or managers.

SIP (Statement of investment principles)

8. A statement of investment principles is a written statement of the investment principles governing decisions about investments for the purpose of the scheme. Under section 35(1) of the 1995 Act trustees must secure that a SIP is prepared and maintained and that it is reviewed and if necessary revised. Under section 36(1) the trustees, or investment manager to whom any discretion has been delegated, must exercise their powers of investment in accordance with regulations made under the 1995 Act and sections 36(3) and (4).
9. The Investment Regulations provide further detail about the content of the SIP under regulation 2(3).

Changes to the Investment Regulations from April 2015

10. We propose to amend the Occupational Pension Schemes (Investment) Regulations 2005 ("The Investment Regulations) to insert a new regulation 2A so that trustees in occupational pension schemes must prepare a statement of the investment principles governing decisions about investments for the purposes of the default arrangement(s) offered by the scheme. This must include a clear statement of the aims, objectives and policies in relation to the investments and how these are intended to ensure that the assets are invested in the best interests of the membership and beneficiaries. Trustees must also review the default strategy and the net performance of the default arrangement.
11. Regulation 4 of the Investment Regulations requires that trustees of schemes with more than 100 members must ensure that the schemes investments are invested in the best interests of members. We propose to insert a new regulation 4A into the Investment Regulations so that where regulation 4 of those regulations does not apply to a scheme (where the scheme has fewer than 100 members), the trustees and any fund manager must ensure that the assets in the default fund are invested in the best interests of members.