SOCIAL FINANCE

Social Finance Limited 131-151 Great Titchfield Street, London W1W 5BB
T +44 (0)20 7667 6370 W socialfinance.org.uk

SOCIAL FINANCE'S RESPONSE TO DWP CONSULTATION ON CHANGES TO THE INVESTMENT REGULATIONS FOLLOWING THE LAW COMMISSION'S REPORT 'FIDUCIARY DUTIES OF INVESTMENT INTERMEDIARIES'

20 April 2015

This document is submitted by Social Finance to the Department of Work and Pensions' consultation on changes to the Investment Regulations following the Law Commission's report 'Fiduciary Duties of Investment Intermediaries'.

Preliminaries

Social Finance is a social investment financial intermediary, established by Sir Ronald Cohen *et al* in October 2007 as a response to the UK Commission on Unclaimed Assets. We have been directly engaged with investors, including pension funds, for over seven years helping them to make social investments and incorporate issues other than solely financial returns into investment portfolios.

Social Finance welcomes the continued commitment by the government through the DWP to investigate the important issue of fiduciary duties. We strongly believe that this is an area lacking clarity and any assistance with this will help to significantly widen the investor base for those who may wish to incorporate Environmental, Social and Governance (ESG) and Ethical issues within their investment portfolios.

Given that Social Finance has limited legal expertise, we have restricted our comments to reflections on how we see the investment market operating and areas where we believe the Law Commission's review could help to improve the situation. Social Finance also refers the DWP to our January 2014 response to the consultation undertaken by the Law Commission as part of the development of their report.

In summary, Social Finance recommends that regulation 2(3)(b) of the Investment Regulations should be amended by separating how trustees have incorporated financially-material and non-financial factors into their investment decisions. Also, the Investment Regulations should be amended to require that trustees should adopt a Stewardship Policy, rather than the UK Stewardship Code. Social Finance also suggests that the degree to which beneficiaries are allowed to countenance financial sacrifice in pursuit of non-financial considerations and their right to consultation are issues that should be the subject of future consultations.

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?

Social Finance welcomes the Law Commission's conclusions 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 issues are financially material they should take these into account[1]; and
- 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[2].

Social Finance strongly supports the concept of amending regulation 2(3)(b) of the Investment Regulations to help clarify trustees' duties and abilities in this regard. As both this consultation and the Law Commission identify, just labelling a factor as "ESG or ethical" is insufficient – it may be financially material, or it may be of particular concern to scheme members, or potentially both. We therefore agree with the consultation's suggestion in paragraph 10 of chapter 2 that *"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."*

This could be achieved with two small changes to the existing regulations. Firstly, the list contained within regulation 2(3)(b) could be kept the same with a small modification to 2(3)(b)(vi) thus:

> (vi) the extent ~~***(if at all)***~~ to which social, environmental***,*** ~~***or***~~ ethical ***or other*** considerations are ***believed to be financially material and*** taken into account in the selection, retention and realisation of investments;

This clarifies 2(3)(b) as a list of purely financial considerations and further wording could be introduced at the start of the clause to emphasise this point if necessary. If trustees feel that there are ESG and ethical factors that are *financially material* to the performance of their investments, e.g. through impacts from climate change or future litigation risk, they should be clearly stated here alongside the other key financial considerations and it is unambiguous as to the reason for their consideration. Trustees would also remain at liberty to state that they believe ESG or ethical factors are not financially material and thus need not be taken into consideration, albeit in a manner that is transparent and explained to members.

[1] DWP consultation, 26 February 2015, chapter 1, paragraph 8
[2] DWP consultation, 26 February 2015, chapter 1, paragraph 9

The second change would be to add a new clause 2(3)(d) along the following lines:

> *(d) their policy with regards to non-financial factors taken into account in the selection, retention and realisation of investments; this may include social, environmental or ethical considerations and should be accompanied by an explanation of why they believe scheme members share this view and why there is no risk of significant financial detriment to the fund.*

This new clause would allow for clear separation of non-financial factors from the aforementioned financial factors, again with full transparency for members. It also gives the opportunity to justify any decisions in terms of alignment with member views and demonstrate why they are not expected to have a significantly detrimental impact on the overall financial return of the fund, as per the Law Commission's conclusions. This continues to enable both 'negative' approaches, e.g. negative screening of tobacco companies, as well as more 'positive' approaches such as proactively investing in social impact or environmental funds.

We note that the same ESG or ethical factors may legitimately appear as both financial and non-financial considerations. For example, the pension scheme of a health-related organisation may wish to avoid tobacco companies because of long-term litigation risk (financially material) and substantial member dislike of the industry (non-financial).

We additionally note the views of some UKSIF members regarding the experience of other countries with similar regulatory changes. Specifically, in order to avoid being overly prescriptive the above suggested changes would allow trustees to simply state "We do not consider such factors" and thus be compliant with the letter, if not the spirit, of the regulation. We therefore also recommend that **the regulations require an explanation as to how the policies were formulated, are monitored on an ongoing basis and the results reported to members**. Such explanations and reports should not be overly long or arduous, but rather a brief reflection of the process that prudent trustees should have undertaken anyway. This requirement would, however, help prevent a circumvention of the process by those who may otherwise be tempted to avoid engaging with such issues.

Social Finance has incorporated the concept of 'no significant financial detriment' into the above as this is aligns with the Law Commission's conclusions. However, we feel it is important to remember that whilst financial considerations are clearly important, **the capital ultimately belongs to the beneficiaries and they should have the right to decide what level of financial sacrifice they are prepared to countenance in order to adhere to a particular set of ESG and ethical standards**. We accept that this likely goes beyond the current level of consultation but strongly encourage the government to explore this perspective further as part of the next stage of this work.

Finally we note that in our original response to the Law Commission's consultation we encouraged the Commission **to enshrine the rights to consultation for beneficiaries and to outline the minimum standards and process for such consultation**. Whilst the above recommendations would constitute a big step forward, trustees still have the option to ignore, or simply not enquire of, membership views. We strongly believe that this is an oversight within the current framework and trustees must make serious efforts to understand the views of those on whose behalf they are managing the assets. We therefore encourage the government to also consider this as part of its ongoing review work post this consultation.

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?

In Social Finance's response to the original Law Commission consultation, we stated *"Social Finance suggests that the Commission recommends that stewardship is clarified as part of a trustee's duty of care and should be exercised either directly or indirectly via third party managers."* We therefore welcome the recommendation to amend the Investment Regulations to require that trustees should become better stewards of the assets in their care. **However, we do not agree that requiring trustees to adopt the Stewardship Code is the right solution.**

The UK Stewardship Code is one of the best such codes currently available and makes for a good behavioural benchmark. However, as noted on the FRC's own website[3], the Code is designed primarily for institutional asset managers and their equity investments in UK listed companies. As such, the Code is inappropriate for all but the largest self-managed pension funds and doesn't encompass a large proportion of a fund's assets. If a single code or approach is required, we would suggest that the National Association of Pension Funds' Principles for Stewardship Best Practice[4] might be more appropriate.

We also note that the area of reporting with respect to stewardship, ESG and ethical activities is undergoing enormous development with numerous standards and codes competing for attention – e.g. Principles for Responsible Investment[5], Global Reporting Initiative[6], Sustainable Accounting Standards Board[7] and the Future-Fit Business Benchmark[8], to name but a few. Any new regulation should therefore allow for the fact that certain new standards may in time supersede, reach further or simply be more appropriate for trustees to adopt than the Stewardship Code. As has been seen clearly through these consultations, the conservative nature of trustees can lead them to follow guidance rigidly even when the original intent was to provide an example of minimum standard and current best practice.

Social Finance therefore recommends that the Investment Regulations are amended to require trustees to adopt a Stewardship Policy. Rather than seeking adherence to a single code, a Stewardship Policy would be a statement of how the trustees intend to undertake their stewardship duties and the standards or approaches they would adopt to achieve this. As with the recommendations in the first section of this document, such a policy should be stated clearly along with an explanation as to how the policy was formulated, monitored on an ongoing basis and the results reported to members. (In line with the government's original proposal, this ensures any trustees would have to explain why they had adopted a Stewardship Policy of **not** undertaking any stewardship activities, had they so chosen).

---

[3] https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx
[4] http://www.napf.co.uk/PolicyandResearch/Corporate-Governance/Responsible-investment-and-stewardship.aspx
[5] http://www.unpri.org/
[6] https://www.globalreporting.org/
[7] http://www.sasb.org/
[8] http://futurefitbusiness.org/

As with the rest of the Investment Regulations, a Stewardship Policy should not be overly prescriptive and allow trustees the freedom to adopt the most suitable approach for their situation. By way of example, a Stewardship Policy might include some of the following undertakings:

- To adopt the UK Stewardship Code *[larger funds]*;
- To only use managers who have adopted the UK Stewardship Code *[smaller funds]*;
- To adopt the Principles for Responsible Investment *[larger funds]*;
- To only use managers who have adopted the Principles for Responsible Investment *[smaller funds]*;
- To vote, directly or by proxy, at the AGM of every UK company in the fund's portfolio;
- To report on the total social and environmental footprint of the fund's portfolio and seek to maximise the positive impacts of the fund wherever possible.

Social Finance believes that this approach achieves the intent of the government and the Law Commission, but will achieve greater participation in stewardship activities from more trustees, will incorporate stewardship of a greater range of assets and is future-proof with regards to changes in standards.

Conclusion

Social Finance welcomes the consultation's recommendations:

- regulation 2(3)(b) of the Investment Regulations should be amended by separating how trustees have incorporated financially-material and non-financial factors, including ESG and ethical considerations, into their investment decisions; this regulation should also require an explanation as to how the policies were formulated, are monitored and the results reported to members; and
- the Investment Regulations should be amended to require that trustees adopt a Stewardship Policy, along with an explanation as to how the policy was formulated, monitored and the results reported to members.

Social Finance also suggests that the following points are considered in future consultations:

- the capital ultimately belongs to the beneficiaries and they should have the right to decide what level of financial sacrifice they are prepared to countenance in order to adhere to a particular set of ESG and ethical standards, and should not be restricted from so doing simply because the financial impact might be material; and
- enshrine the rights to consultation for beneficiaries and to outline the minimum standards and process for such consultation.

We trust that the government will find these thoughts helpful and we remain at your disposal to discuss any of these issues in more detail.

Martin Rich
Social Finance Ltd