UKSIF

Holywell Centre
1 Phipp St, London EC2A 4PS
Tel: 020 7749 9950
Email: info@uksif.org
Web: www.uksif.org

16 December 2008

The Regulated Community Learning Team
The Pensions Regulator
Napier House
Brighton BN1 4DW
Email: kate.gerrard@thepensionsregulator.gov.uk

Dear Ms Gerrard

Response of UKSIF, the sustainable investment and finance association, to The Pensions Regulator Consultation Document: Review of the Trustee Knowledge and Understanding (TKU) code of practice (code of practice 7) and scope guidance

Thank you for the opportunity to respond to this consultation document. Our comments relate to the scope guidance documents. Numberings are taken from the draft guidance for defined benefit schemes with associated defined contribution arrangements but our comments relate broadly to all three draft scope guidance documents.

Summary

All trustees need knowledge and understanding that enables them to address:

1. Responsible asset ownership, including Principle 5 (Responsible Ownership) of the updated principles supported by the Investment Governance Group
2. The “ESG disclosure regulation” which forms part of Statutory Instrument 1999 No. 1849.

UKSIF believes that the increased importance of these areas since the original scope guidance was published in 2005 justifies a strengthening of the associated TKU requirements.

We are disappointed that the proposed 2008 scope guidance documents appear to take the opposite approach. Rather than giving a stronger emphasis to responsible ownership and ESG issues compared with the 2005 scope guidance documents, the 2008 text appears to remove or reduce the related TKU requirements. In our view, the 2008 documents not only fail to address these areas of knowledge and understanding adequately but also give a potentially misleading impression to trustees of their legal responsibilities in relation to ownership and ESG disclosure.

We note that The Pensions Regulator wishes to keep changes to the scope guidance to a minimum. In the light of this, we would highlight that reverting to the 2005 text would be preferable to retaining the 2008 draft text.

However, we do believe that strengthened requirements are needed and can be justified. The Pensions Regulator, the government, leading trade bodies and other organisations have increased their emphasis on ownership and ESG issues since 2005. In addition, a range of leading commentators have proposed that ownership failures by major asset owners were a significant contributor to the current financial crisis.

We would be delighted to discuss suitable new wording further with you, including the appropriate approach for small fully insured DC schemes.

Understanding Responsible Ownership

There is an emerging view that failure by major asset owners, including fiduciaries, to provide effective stewardship of the assets that they hold has been a significant contributor to the current financial crisis. For example, Mark Goyder of Tomorrow's Company has said "The crisis is a failure of ownership and we have to learn the lesson" (FTfm, 8 December 2008).

Increased Emphasis from The Pensions Regulator / the Investment Governance Group

The Pensions Regulator has recently increased its support for responsible ownership. In particular, the Investment Governance Group has been created, chaired by The Pensions Regulator, to take forward the Myners Principles. Best practice guidance on the updated principles, including Principle 5 (Responsible Ownership) appears on The Pensions Regulator's web site.

The introduction to the updated principles states:

> The high level principles will be the accepted code of best practice throughout the industry in investment decision-making and governance. It is expected that trust boards will report against these on a voluntary 'comply or explain' basis.

Principle 5 states:

- Trustees should adopt, or ensure their investment managers adopt, the Institutional Shareholders' Committee Statement of Principles on the responsibilities of shareholders and agents.
- A statement of the scheme's policy on responsible ownership should be included in the Statement of Investment Principles.
- Trustees should report periodically to members on the discharge of such responsibilities.

Increased Emphasis from NAPF / ABI / Others

Since 2005, the National Association of Pension Funds (NAPF) and the Association of British Insurers (ABI) have re-emphasised their support for responsible ownership.

For example, the NAPF Corporate Governance Policy and Voting Guidelines (published Nov 2007) states:

> NAPF believes that the informed use of votes is an obligation (although not a legal duty) of owners and an implicit fiduciary duty of Trustees….. Engagement with companies is seen as a necessary part of good ownership.

The NAPF Guidelines also include a section on ESG (Part 3). This sets out the NAPF's recognition of the importance of incorporating ESG considerations into investment decisions. It argues that pension funds should benefit from the application of ESG principles in terms of long term financial performance, alignment of pension fund and societal objectives and management of reputational risk.

In the introduction to its Responsible Investment Disclosure Guidelines (Jan 2007), the ABI states:

> ABI members recognise that it is also incumbent on institutional investors to consider these [ESG] risks and opportunities in the context of their overarching objective of enhancing shareholder value. Addressing them should be an integral part of the investment process, rather than a separate "add-on" consideration.

Others have also increased their emphasis on responsible ownership and responsible investment. For example the International Corporate Governance Network's "Statement of Principles on Institutional Shareholder Responsibilities", adopted in 2007, states "The ownership of equity carries important responsibilities, particularly due to the voting rights that can influence the way in which a business is conducted. Ultimate owners cannot delegate these responsibilities. Even when they employ agents to act on their behalf, it is up to beneficial owners to ensure that the responsibilities of ownership are fulfilled by those agents."

Reduced not Increased Emphasis in Draft Scope Governance

In these circumstances, we would expect to see a stronger focus on asset stewardship and responsible ownership within the proposed scope governance for all pension fund trustees. Instead, such a focus is notable by its absence.

Unit 9 (on fund management) of the 2005 scope guidance recognised the importance of ownership by highlighting (9c) the ownership of assets - especially the implications for trustees in relation to corporate governance. There appears to be no equivalent or stronger text in the 2008 draft scope guidance.

Understanding the ESG Disclosure Regulation and associated Requirements

"The Occupational Pension Schemes (Investment, and Assignment, Forfeiture, Bankruptcy etc.) Amendment Regulations 1999" (Statutory Instrument 1999 No. 1849) includes the text:

> **Additional content of statement of investment principles**
> 11A. The matters prescribed for the purposes of section 35(3)(f) of the 1995 Act (other matters on which trustees must state their policy in their statement of investment principles) are –
>
> (a) the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments; and
>
> (b) their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to investments.

In this response, we have referred to this part of Statutory Instrument 1999 No. 1849 as "the ESG disclosure regulation".

Increased Emphasis on Legal Requirement
Since 2005, there has been a growing emphasis on environmental, social and governance (ESG) issues in investment.

For example, speaking in the House of Lords during the passage of the 2008 Pensions Bill, Lord Mackenzie said

> Furthermore, as the noble Lord, Lord Skelmersdale, and others have identified in recognition of the importance of responsible investment, current law already requires the trustees of pension schemes to prepare a statement of investment principles which must be made available to members and prospective members. It sets out the guidelines which fund managers must follow in investing members' funds. In the statement of investment principles, trustees of pension schemes must already state to what extent social, environmental or ethical considerations are taken into account. *That is an obligation on trustees—not simply a right or an option. (Italics added.)*

and

> *There is no reason in law why trustees cannot consider social and moral criteria in addition to their usual criteria of financial returns, security and diversification.* This applies to the trustees of all pension schemes. *(Italics added.)*

(Ref: http://www.publications.parliament.uk/pa/ld200708/ldhansrd/text/81007-0011.htm)

To give another example, Freshfields Bruckhaus Deringer, a leading international law firm, produced the report "A legal framework for the integration of environmental, social and governance issues into institutional investment" addressing the legal position across seven jurisdictions. This concluded that "integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions."

(Ref: http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf)

Reduced not Increased Emphasis in Draft Scope Governance
In our view, the ESG disclosure regulation means that trustees need knowledge and understanding of the integration of environmental, social and governance issues (ESG issues) into investment decision making and of responsible ownership practices by asset owners.

Unit 11 of the 2005 scope guidance recognised the ESG disclosure regulation by highlighting the need for trustees to be familiar with and able to make use of the Statement of Investment Principles (SIP) in relation to (11h) socially responsible investment and corporate governance.

This reference to socially responsible investment and corporate governance in the 2005 scope guidance has been replaced. The relevant text now reads:

> **Unit 11 – A working knowledge of the scheme's Statement of Investment Principles (SIP)**
> *11a Roles and responsibilities for preparing the SIP*
> *11b The scheme's investment objectives and asset allocation strategy*
> *11c The contents of the SIP*
> Including the requirement for trustees to take account of corporate governance and social responsibility on the part of the companies in which they invest (where appropriate)

ESG issues address significantly wider issues that the social responsibility of companies, whether held as public equity or private equity, and the phasing of the reference to corporate governance seems to suggest that it relates to the activities of companies rather than of their shareholder owners.

In our view, the scope guidance now fails to require trustees to develop the knowledge and understanding that they need to meet the obligation highlighted by Lord McKenzie and indeed it potentially misrepresents the legal requirements of this regulation.

Our Review of the Scope Guidance

In drawing the conclusions given above, we have reviewed the full scope guidance. In addition to the text quoted above, we identified the following text potentially relevant to responsible ownership and ESG disclosure:

> **Unit 1 – The law relating to trusts**
> **…1b Fiduciary duties**
> Including the obligation to act prudently, safeguarding the financial interests of all beneficiaries …
> **…1o Trustees' responsibilities for sound governance and administration**

> **Unit 9 – Fund management**
> …**The mechanisms for monitoring investment arrangements and fund managers**
> Including: …
> ● compliance with the statement of investment principles (SIP)

> **Unit 13 – A working knowledge of the scheme's other relevant documents**
> These include: …
> ● Regular stewardship reports …
> ● Statement of compliance with the Myners' Principles (where appropriate) …

In our view, even when considered together, this text is insufficient to communicate the requirement for knowledge and understanding of responsible ownership and the requirements of the ESG disclosure regulation.

UKSIF – the Sustainable Investment and Finance Association

UKSIF is the sustainable investment and finance association. We promote responsible investment and other forms of finance that support sustainable economic development, enhance quality of life and safeguard the environment. We also seek to ensure that individual and institutional investors can reflect their values in their investments.

Our overall strategic objective is to ensure that the UK finance sector is the world leader in advancing sustainable development through financial services.

UKSIF was created in 1991 to bring together the different strands of sustainable and responsible finance nationally and to act as a focus and a voice for the industry. UKSIF's 200+ members and affiliates include pension funds, institutional and retail fund managers, investment banks, financial advisers, research providers, consultants, trade unions, banks, building societies and non-governmental organisations.

In January 2009, UKSIF will change its name from “UK Social Investment Forum” to “UK Sustainable Investment and Finance” to better reflect its mission. Information on UKSIF is available at www.uksif.org.

With best wishes

Penny Shepherd

Penny Shepherd MBE
Chief Executive