OWNERSHIP DAY

USE SHAREHOLDER RIGHTS TO IMPROVE YOUR RETURNS

Understanding and applying fiduciary duty

The trustee best practice guide

The latest legal and regulatory thinking

...

Duties of pension and charity fund trustees

...

Requirements for both DB and DC schemes

...

Best practice advice

2nd Edition, 2017

HSBC Global Asset Management

UKSIF UK Sustainable Investment and Finance Association

Foreword

"Environmental, social and governance issues can no longer be ignored by trustees."

That was the clear message from the Chief Executive of The Pensions Regulator (TPR), Lesley Titcomb, at UKSIF's 25th anniversary lecture in November. It complemented last year's Ownership Day best practice guide when we wrote about how the concept of fiduciary duty was evolving. New guidance for both defined-contribution (DC) and defined-benefit (DB) schemes which has come from TPR in recent months is its most recent evolution.

A little history: Fundamentally fiduciary duty is about acting in the best interests of beneficiaries, but some queried what this meant. We have heard stories of schemes trying to change their investment approach but receiving advice that it would be in breach of their fiduciary duty. For long-term responsible investors, this has often presented a problem.

The 2012 Kay Review found that some trustees were using a very narrow interpretation of fiduciary duty. These trustees focussed on maximising short-term financial returns over consideration of factors which might be material over the longterm. Subsequently, the Law Commission published its report into the fiduciary duties of investment intermediaries in 2014 and provided an extremely helpful clarification:

"Whilst it is clear that trustees may take into account environmental, social and governance factors in making investment decisions where they are financially material, we think the law goes further: trustees should take into account financially material factors."

UKSIF rightly celebrated this success and has since been working to turn that thinking into action. The new guidance from TPR for both DB and DC trustees is warmly welcomed. **This updated review of fiduciary duty in the UK aims to summarise the key messages in that guidance and outline TPR's expectations of pension trustees in this area. We also comment again on recent thinking on fiduciary duty in charity investment; there now seems to be a worrying gap between what is expected of pension trustees and charity trustees.**

Thank you to our sponsor HSBC Asset Management and to my colleague Fergus Moffatt, Head of Public Policy and Programme Director for his help writing this guide.

Simon Howard
Chief Executive
UK Sustainable Investment and Finance Association

April 2017

UKSIF
UK Sustainable Investment and Finance Association

"Fiduciary duty is a core responsibility for trustees who must act in the best interests of their scheme beneficiaries..."

We are delighted to sponsor UKSIF's trustee best practice guide on understanding and applying fiduciary duty.

Fiduciary duty is a core responsibility for trustees who must act in the best interests of their scheme beneficiaries in order to assure that members can enjoy a decent income in retirement. In today's low return environment this can present a significant challenge for trustees.

We believe that the integration of material ESG issues into investment decisions and robust investor stewardship through company engagement and voting can help reduce investment risk and protect and enhance investment returns. We also believe that members' views are evolving and that scheme beneficiaries increasingly expect issues such as climate change, unsustainable business practices and unsound corporate governance to be addressed in the investment strategy and approach.

In that context , we welcome the updated TPR guidance for DC and, most recently, DB scheme trustees that clarifies trustees' legal obligations to take ESG factors into account, as these risks could be financially significant both over the short and long term.

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- **The Law Commission summarised the position on fiduciary duty in 2014**
- **In the light of this, the Pensions Regulator has now given guidance for DC and DB trustees**
- **DB trustees are "required" to consider financially material factors**
- **Non-financial factors, such as quality of life, may be considered by trustees subject to two tests**

Financially material and non-financial factors

Last year we covered the Law Commission's report into the fiduciary duty of investment intermediaries. Legally, the "Investment Regulations" require trustees to prepare a Statement of Investment Principles ("SIP") stating their investment policy, including the extent (if at all) to which "social, environmental or ethical" considerations are taken into account. This "SEE" clause was identified by the Law Commission as being particularly confusing for trustees, and the Commission argued reference to financially material and non-financial factors was preferable.

The following is a summary of the Law Commission's view on consideration of financially material and non-financial factors.

Financially material factors

The Law Commission removed misconceptions over the extent to which fiduciary duty prevented trustees from taking financially material factors into account by stating:

"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)."

Thus, there is no legal impediment to trustees taking account of environmental, social or governance factors where they are - or may be - financially material. But the Law Commission went further than this by stating *"the law goes further: trustees should take account of financially material risks".*

The conclusion is simple: If the risk is material, it should be considered.

Non-financial factors

Non-financial factors are those which might influence investment decisions motivated by concerns such as improving members' quality of life or showing disapproval of certain industries.

The Law Commission illustrated the distinction between financially material factors and non-financial factors:

"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."

Generally, non-financial factors may be taken into account provided 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 (except in "chosen" DC funds).

The conclusion: Investing inline with the trustees' personal beliefs should be avoided but trustees do have the discretion to think about member views and how these might be reflected.

This statement of the law outlined by the Law Commission with regard to both financially material and non-financial factors has been faithfully reproduced in TPR's guidance for DC and DB trustees.

Trust-based Defined-Contribution Schemes

The DC investment governance guidance which was published last summer as part of a revised DC Code represented the first time the Law Commission's thinking had been transposed into rules for trustees. The significance of the guidance was made clear by TPR's Executive Director for Regulatory Policy, Andrew Warwick-Thompson who said at the time:

"With regards to ESG our guidance is clear that we expect trustees to take ESG issues into account when assessing portfolios over the long term... I would urge any trustee or asset manager out there who still thinks these things don't matter to wake up and smell the coffee."

In its investment governance guidance for DC trustees, TPR states:

- Trustees **should** take into account factors which are financially material to the performance of an investment;
- Where trustees think environmental, social and governance (ESG) factors are financially significant, you should take these into account;
- Likewise if you think certain ethical issues are financially significant.

So the debate clearly moves to understanding which factors are financially material. Trustees' own discussions with their advisers will help to resolve this, but TPR offers some insight:

"You should bear in mind that most investments in DC schemes are long term and are therefore exposed to the longer-term financial risks. These potentially include risks relating to factors such as climate change, unsustainable business practices, unsound corporate governance etc. These risks could be financially significant, both over the short and longer term."

"With regards to ESG our guidance is clear that we expect trustees to take ESG issues into account when assessing portfolios over the long term... I would urge any trustee or asset manager out there who still thinks these things don't matter to wake up and smell the coffee."

Andrew Warwick-Thompson, The Pensions Regulator

Defined-Benefit Schemes

The most recent guidance published last month for **DB schemes, not only levelled the playing field for trustees, but may have gone even further than the DC guidance. The advance comes in the form of guidance which is not only more stringent on trustees, but which also provides more support in determining which factors may be financially material.** We note (and welcome) this further evolution in the concept of fiduciary duty and in the expectations placed on trustees in respect of the investment process. We would expect the DB standard to operate across all trustee-based pension funds in due course.

The DB investment guidance states:

- You **need** to take environmental, social and governance factors into account if you believe they're financially significant;
- You **are required** to take into account factors that are financially material to investment performance;
- Where you think environmental, social and governance factors or ethical factors are financially material, you **should** take these into account.
- The law is sufficiently flexible to allow you to take non-financial factors into account.

The new guidance contains useful examples and learning points to show how this thinking can be put into practice as trustees review the statement of investment principles. To share an example, TPR uses climate risk as an instance of trustees fulfilling their investment obligations. They start with an investor statement to show understanding of the issue:

"As long-term investors, we believe climate risk has the potential to significantly affect the value of our investments".

Then TPR shows how this might be further developed in their statement of principles:

"They develop this belief in the SIP as follows:

- *We expect fund managers to have integrated climate risk into their risk analysis and investment process.*
- *We will try to ensure that we manage all new and existing investment arrangements in a way that takes account of climate risk.*
- *In monitoring the performance of our fund managers, we will also regularly consider how they are performing with reference to climate risk issues.*

In addition, the trustees decide to report annually to members on how the climate risk policy has been applied.

***Learning Point**: Many factors can impact investments over the long term. Where you consider these to be financially material, you are required by law to factor them into your investment decision-making."*

This example is helpful in reinforcing the fact that climate change may be financially material. A recent poll found that 53% of trustees, scheme managers and pension professionals did not consider climate risk to be a material factor. UKSIF thinks this guidance sends a clear message on the regulator's position.

It seems to us that there are two linked key points in this area:

1. **The Pensions Regulator wants trustees to consider financially material factors even if they are environmental, social or governance in nature and**
2. **TPR has moved from saying trustees "should" consider them to saying trustees are "required" to consider them.**

ESG has to be done and this message is getting louder.

Stewardship and engagement

Stewardship is a key activity for long-term responsible investors and inextricably linked to fiduciary duty. The Law Commission reviewed its role in the investment process and its views were mirrored by both pieces of TPR investment guidance.

According to the Law Commission, stewardship entailed *"promoting the long-term success of a company through monitoring and engagement, whether that engagement is formal (for example through voting) or informal (through communications and discussions)".* A well-run company is far more likely to perform over the long term and Professor Kay saw stewardship as a central function of equity markets. In the Stewardship Code, the Financial Reporting Council states that *"stewardship aims to promote the long-term success of companies in such a way that the ultimate providers of capital also prosper".*

These three sources form the basis for TPR's guidance on investment stewardship. When the DC investment guidance was published, TPR noted that for most schemes, stewardship activities are likely to be undertaken by the fund manager, but encouraged trustees to become familiar with the manager's policies and *"where appropriate, seek to influence them".*

The guidance also encourages trustees to agree specific voting criteria with managers where appropriate. Alternatively, TPR suggests trustees ask questions of their managers such as:

- Who is the proxy voting adviser?
- How often have they disagreed with the adviser's recommendations, and are there particular issues on which they consistently disagreed?
- Are there any instances where they did not cast votes at all – for example, in specific markets – and why?

Interestingly, as with the DC investment guidance, TPR has added to the strength of the message in the more recent DB investment guidance. In addition to the above questions, it is suggested that trustees also ask the manager *"can you provide voting records?"* with the implication (presumably) that they be monitored.

Further, the guidance recommends that while reviewing manager performance *"trustees should evaluate the manager's actions regarding ESG factors and shareholder engagement"* including requesting summaries of the manager's voting activity and engagement records.

Finally, the guidance suggests trustees may wish to form *"meaningful policies on long-term sustainability, how you apply the principles of the Stewardship Code, and how you will take non-financial factors into account".*

Asset owners are the providers of capital and should set the tone for stewardship activities which they may delegate to managers. We fully endorse the new requirements on trustees in relation to their stewardship duties and suspect there may be some utility in a review of the Stewardship Code by the FRC to bring it more in line with TPR's expectations.

Charity trustees

- A QC has suggested that investments in companies selling alcohol, tobacco or arms may be "socially costly" and may be "pregnant with financial risk"
- He suggests that corporate law means corporate trustees have a positive duty to consider the charity's impact on a range of issues and that this should be considered in setting investment policy
- Carbon intensive investment may be "irreconcilable" with certain charitable purposes including relief of poverty, environmental purposes and health
- Trustees should take independent and impartial advice

There is quite a contrast between the progress in clarification of what is expected in pension fiduciary duty and the relative lack of activity in charity fiduciary duty.

In the latter area there is little to report. Here we give a further precis of a legal opinion on the topic which to the lay reader has clear echoes of what has happened in pensions. The opinion suggests a clear direction of travel.

The McCall opinion

In 2015 Bates Wells Brathwaite, funded by the Sainsbury Family Charity Trusts, commissioned a written opinion from Mr Christopher McCall QC on *"The powers and duties of charity trustees as to ethically questionable investments with specific reference to carbon intensive assets".* The opinion suggests a more radical approach may be necessary on the part of charity trustees, particularly when investing in carbon-related assets. This summary is a brief review of the opinion.

McCall QC draws a distinction between *"patent"* and *"latent"* investment conflicts for trustees.

The former are where an investment conflicts with the objects for which the charity exists and where the charity **must** divest regardless of financial consequences; the latter are where the conflict is less obvious and the trustees must weigh the risks to the charity's work against the investment risk of divestment.

Running through all this is recognition that today's asset prices do not reflect all the relevant factors. This may be true particularly for carbon-intensive assets, but also of others which are potentially *"socially costly assets"*, meaning they may be taxed or regulated in future to mitigate social impacts and costs. The opinion uses the memorable phrase *"pregnant with material financial risk"* which echoes the Law Commission.

McCall reminds us that there are limits on the degree to which trustees can invest driven solely by their *"ethics"* but in what we see as an important development he says :

"Without hesitation I would however stress that it seems to me that these financial and non-financial (i.e. ethical) types of objection cannot be kept entirely separate the one from the other, because as indicated above, a growing sense of principled objection may be reflected in a socially costly asset becoming taxed, subject to licences or other permissions or regulated, and its financial value may reduce as a result."

Then Mr McCall considers how statute law bears on directors of a corporate charity. He says statute law means that directors:

"have the duty of having regard to the impact of the company's operations on the community and the environment, the desirability of the company maintaining a reputation for high standards of business conduct, and the likely consequences of any decision in the long term."

He believes that these criteria need to be applied to the management of investments. His conclusion is that in the case of corporate charities, corporate trustees need to consider whether they should exclude investments which might be harmful to the community or the environment, or might damage the reputation of the charity or of the charity sector at large. That reputational risk element mirrors guidance from the Charity Commission (CC14).

Christopher McCall QC then further considers the Trustee Act 2000 and section 172 of the Companies Act 2006 and says that these laws:

"...have, I think, given room to argue that there is scope and, to a certain extent, an obligation to consider the adoption of a more developed sense of social responsibility in matters of investment....it seems to me strongly arguable that charity trustees may and, in some cases, should take a broader view of their investment responsibilities and the suitability of particular species of investment to their trust than has hitherto been thought to be the case."

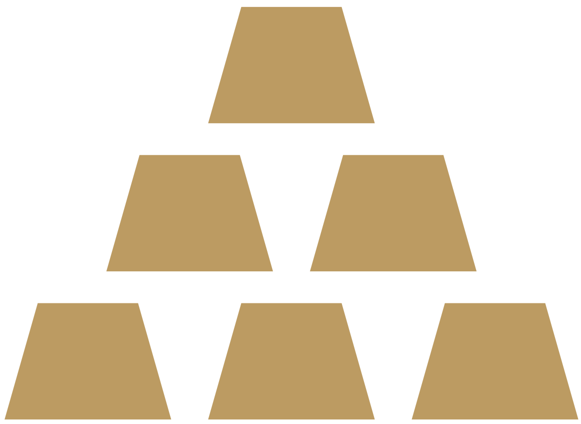
The use of *"should"* is important as it shows how necessary he sees consideration of the issue. This level of urgency is echoed in the Law Commission finding but has been raised further in importance by TPR's more recent *"required".*

Mr McCall goes on to say which types of charity – the *"some cases"* – should be taking a broader view of their investment responsibilities are with respect to carbon assets, the topic of the opinion.

"..I think it at least arguable that investment in carbon intensive assets could be said to be irreconcilable with the intent behind charities with:

- *general or specific environmental purposes;*
- *general health purposes;*
- *general poverty purposes; and*
- *other purposes relating to matters where the properties of carbon intensive assets and the consequences of dangerous climate change are of particular concern."*

Mr McCall recognises that it may not be easy to identify if there is a conflict between the purpose of the charity and proposed investments. This is the latent conflict referred to earlier. In such cases he maintains that a cautious approach is needed. If an adviser highlights material financial risks in the investments then *"it must be proper"* to ignore those investments; if the advice is less strong then such investments may be ignored if there is no material risk of financial detriment from excluding them. These are clearly broad criteria and Mr McCall does see the issue as very broad.



As Mr McCall outlines his deductions, he stresses that the courses of action he believes are permitted may only be taken after *"advice"*. We do not see this advice burden as excessive, but we recognise it may require an evolution in behaviour. Many charity service providers will be able to provide data on weightings, past performance and other relevant factors which could inform the trustee debate. Fund managers who have properly considered the issues at stake should be willing to discuss the extent to which prices do or do not reflect conceivable risks.

Conclusions

Christopher McCall QC concludes by saying that a reference to the charity tribunal would be useful as would Charity Commission guidance. We entirely agree. The first part of this report shows how far thinking in pension fiduciary duty has moved and McCall is showing us that there are issues in the charity field. It seems wrong that charity trustees cannot turn to proper, up-to-date guidance.

Our interpretation of the McCall opinion is that charity trustees would be well advised to consider this latest thinking on their fiduciary duties. We suggest the following:

First, consider if there is a conflict between your charitable purpose and your investments. If there is, you should act. A frequently cited example is of a cancer charity holding tobacco shares.

Second, consider Mr McCall's view that trustees now need to think about the issue of latent conflict. Thus, he says concerns, for instance on how investments affect the community and the environment, will require thought. His list of purposes highlighting those charitable areas most affected should probably be considered too.

Third, consider how you can ensure that these matters aren't forgotten. We would suggest putting the matter on your risk register and raising the issue annually with your advisers and/or fund managers.

"...consider if there is a conflict between your charitable purpose and your investments. If there is you should act. A frequently cited example is of a cancer charity holding tobacco shares."

Other policy and sector developments

It is not just TPR that has taken positive steps with regard to responsible investment. Since the Law Commission's 2014 report, momentum has continued to grow elsewhere too.

New rules for the Local Government Pension Scheme require those funds to publish an Investment Strategy Statement (ISS) which replaced the now defunct SIP. The ISS requires administering authorities to make publicly available statements on their approach to investment. Amongst other things this must include their policies on incorporating non-financial factors, ESG factors and their approach to social investment. These rules are far more modern and relevant to current investment practices than those for trustees of occupational pension schemes, although TPR guidance does partly address the issue.

It is also noteworthy that the recently passed IORPs II Directive should be transposed by the UK Government before the UK leaves the European Union. This Directive requires occupational schemes in Europe to act in accordance with the *"prudent person"* rule and publicly state how their investment policies take ESG factors into account.

This all comes at a time when the Government is actively considering ways to "mainstream" social investment. We are expecting a response from the Law Commission on its recent review of pension funds' ability to make social investments. We welcomed that review but highlighted several challenges including understanding of the concept of fiduciary duty.

The Need for Government Action

It seems as though the only place left to embrace the shift towards more responsible ways of investing is the Department for Work and Pensions.

Despite the Law Commission's clear call to action on fiduciary duty in 2015 the Government failed to act to provide clarity for trustees. **TPR's work to provide clarity has been very helpful; trustees nonetheless now operate in an environment where regulatory guidance is out of sync with legislative requirements.**

Given the strength of feeling amongst sector respondents to the consultation (95% of respondents called for changes to the law) and the uneven playing field across the UK pensions landscape, **we think there is a strong case for the Government to provide the ultimate clarification, in statute, on which and how factors are considered during the investment process**. Specifically, the Government should provide clarity on the differences between financially material and non-financial factors in the Occupational Pension Schemes (Investment) Regulations and require schemes to state the extent to which these factors are considered.

Best practice for trustees

Pension fund trustees

Pension fund trustees should understand the meaning and investment implications of TPR's guidance on financially material and non-material factors as outlined on pages 5-7

In particular, trustees should be aware that:

1. **The Pensions Regulator wants trustees to consider financially material factors even if they are environmental, social or governance in nature and**
2. **For DB trustees, TPR has moved from saying trustees "should" consider them to saying trustees are "required" to consider them.**

Trustees should also familiarise themselves with the guidance on stewardship on pages 8 and 14 on investment techniques.

Charity trustees

Charity trustees need to consider their response to the McCall QC opinion and in particular their view on two points:

1. If they are corporate trustees they need to consider whether aspects of the Companies Act on, say, environmental matters should influence their investment approach (page 10) and

2. All charity trustees should consider Mr McCall's view that there is a conflict between some broad, traditional charitable purposes and investing in carbon-intensive assets (page 10).

Trustees should weigh up the following when making a divestment decision:

- Qualified and independent financial advice.
- The percentage of the market that would be excluded if they followed the McCall QC view that they should divest.
- The most authoritative and current scientific evidence on causes and effects of climate change.

Where there is no clear conflict between an investment and the charitable mission, trustees must show they are not making moral gestures by divesting but a financial one
In addition we think charity trustees should consider whether to adopt the stewardship approach outlined by TPR on pages 8 and 14.

Ways to do it

A Risk Register

Trustees should consider identifying and assessing the key risks to their fund with their advisers and allocating responsibility for managing and mitigating those risks. For pension trustees some kind of process like this is probably essential in meeting various pieces of TPR guidance and in evidencing that meeting.

The risk register should include the likelihood of the risk materialising and the severity of the impact if it does. As TPR has made clear, ESG factors are very likely to be financially material. Assessing these risks and understanding who can help the trustees meet their responsibilities will ease the trustee burden.

The Pension Regulator website has many references to risk registers and several local government pension scheme registers are on the internet.

Investment beliefs, manager selection and monitoring

Trustees of all kinds should consider outlining their investment beliefs at the outset of the investment process. In its guidance to DB trustees TPR gave 7 example beliefs including *"Investing responsibly and engaging as long-term owners reduces risk over time and may positively impact scheme returns."*

Beliefs should influence manager selection and monitoring - you need managers that can reflect your beliefs and to be sure they are doing so. The PLSA has provided guidance on manager selection, available in its recent Environmental, Social and Corporate Governance (ESG) Made Simple guide. Suggested discussion areas with potential managers include:

- **RI policy and governance:** What motivates you (the asset manager) to look at ESG issues (rationale behind responsible investing)?
- **ESG resources:** How are your portfolio managers incentivised to incorporate ESG factors?
- **ESG integration:** How are ESG factors incorporated into the investment analysis and decision-making processes?
- **Voting and engagement:** Do you have examples of engagement/where you have engaged a company and what you have achieved?
- **Monitoring:** How often and through which communication channels (meetings, written reports etc) are RI activities reported to pension funds?

Stewardship

Trustees of all types should affirm their commitment to well-governed companies. This might include:

- Signing the Stewardship Code or explaining why this was considered not to be relevant to them;
- Asking their agents to do the same and requesting information from agents such as:
    - Who is their proxy voting adviser?
    - How often have they disagreed with the adviser's recommendations, and are there particular issues on which they consistently disagreed?
    - Are there any instances where they did not cast votes at all – for example in specific markets – and why?
    - Can they provide a summary of engagement activities and voting records?
- Annually publishing their approach to stewardship including how they comply with the principles of the code;
- Annually publishing how their expectations regarding stewardship are conveyed to their agents and the methods by which they monitor agents' activities on their behalf;
- Annually publishing a report outlining, where appropriate to commercial sensitivity, activities carried out on their behalf over the previous 12 months and how they have met their expectations.

Ongoing support and knowledge

Trustees should keep up to date with fiducariary duty developments, ESG and long-term investment issues and the progress of their peers by:

- Joining UKSIF (asset owners join as free affiliates).
- Joining your national SIF if not UK-based.
- Becoming a signatory to the PRI.
- Becoming an investor signatory at CDP.

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Ownership Day

Ownership Day is a national UKSIF initiative to encourage the financial benefits of active ownership and encourage investors to value high-quality active ownership strategies.

www.ownershipday.co.uk

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The UK Sustainable Investment and Finance Association (UKSIF) is the membership association for sustainable and responsible financial services.

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.

www.uksif.org

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HSBC Global Asset Management is a signatory to United Nation Principles for Responsible Investment from June 2006 and to the Montreal Carbon pledge since September 2015

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