

# TEESSIDE PENSION FUND

Administered by Middlesbrough Council

AGENDA ITEM 7

## TEESSIDE PENSION BOARD REPORT

1 FEBRUARY 2016

CHIEF FINANCE OFFICER - PAUL SLOCOMBE

### LEGAL ADVICE AVAILABLE ON ETHICAL INVESTMENTS

#### 1. PURPOSE OF THE REPORT

- 1.1 Following a review of the minutes for the Teesside Pension Fund & Investment Panel (the Panel) meeting held on 17 June 2015, Teesside Pension Board Members requested a report on the legal advice available in relation to ethical investments and Panel Members' fiduciary duties.

#### 2. RECOMMENDATIONS

- 2.1 That Members note the report.

#### 3. FINANCIAL IMPLICATIONS

- 3.1 There are no financial implications arising from this report.

#### 4. STATEMENT OF INVESTMENT PRINCIPLES

- 4.1 The Local Government Pension Scheme (Management and Investment of Funds) (Amendment) regulations 1999 require that the Fund prepare, publish and maintain a Statement of Investment Principles (SIP). It is required that the published SIP includes a statement to the extent, if at all, social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments.
- 4.2 A report to the Investment Panel on 12 March 1999 established the Fund's position on ethical investments. This has since been amended and approved by the Panel, the last occasion being March 2015, and the current position is:

*"As a responsible investor, the Teesside Pension Fund wishes to promote corporate social responsibility, good practice and improved company performance amongst all companies in which it invests. The Fund will therefore monitor investee companies to ensure they meet standards of best practice in relation to their key stakeholders. The Fund considers that the pursuit of such standards aligns the interests of the Fund members and beneficiaries with those of society as a whole. In furtherance of this policy, the Fund will support standards of best practice on disclosure and management of corporate social responsibility by companies and will pursue*

*constructive shareholder engagement with companies on these issues constituent with the Fund's fiduciary duties.*

*The Fund will explicitly consider climate change risks and opportunities in the investment process and engage with companies in which we invest to ensure that they are minimising the risks and maximising the opportunities presented by climate change and climate policy.*

*The Fund has adopted the Institutional Shareholder's Committee Statement of Principles and members will agree and periodically review its implementation.*

*In accordance with this policy, the Fund will seek where necessary through its own efforts and in alliance with other investors to pursue these goals. To this end the Fund is an active member of the Local Authority Pension Fund Forum."*

4.3 There are three practical ways of implementing an ethical, environmental and socially responsible investment policy; negative screening, positive screening, and active engagement.

4.3.1 **Negative Screening:**

This is the process of avoiding the purchase of, or deciding to sell shares in a company because it fails agreed ethical, environmental or social criteria. This approach is open to legal challenge for pension funds on the grounds that restricting investments may damage financial returns and will increase volatility and risk. Negative screening is also criticised since it does not influence companies to change.

4.3.2 **Positive Screening:**

This is the process that favours investment in companies whose record is considered ethically, environmentally and socially acceptable. Positive screening provides a framework for selecting companies on the basis that they exhibit socially responsible features that will enhance corporate performance. Such an approach requires continuous monitoring of company behaviour, which for a pension fund with global investments requires significant resources.

4.3.3 **Active Engagement:**

Most funds adopt a policy of active engagement with the companies in which they invest. This typically takes the form of exercising voting rights at company Annual General Meetings, but can involve direct contact with the invested companies over specific issues. The range of issues which active engagement covers is wider than ethically, environmentally and socially responsible investments, and has a greater impact on how companies conduct their business.

4.4 The Teesside Fund was run on a basis of very limited negative screening until the corporate governance policy was adopted in 1995, when it switched to active engagement. To start restricting investments on ethical grounds will require the Fund to reverse this policy, and decide whether to implement the new policy with either negative or positive screening.

4.5 With a new screening process in place, the extent of the restrictions needs clarification. Adoption of a policy of restricting investments will leave the Fund vulnerable to approaches to other special interest groups advocating a similar policy towards companies involved in other businesses also considered unethical.

## 5. FIDUCIARY DUTY & CASE LAW

5.1 Fiduciary duties set out the broad parameters within which trustees (and the Independent Investment Advisors and in-house fund management team) must exercise the discretionary powers conferred by the terms of the Local Government Pension Scheme's regulations. These duties affect the exercising of discretion to make and manage investments, and require trustees and their agents to act prudently and for a proper purpose. As seen in the Law Commission's report, discussed later in this report, a combination of statute and case law has articulated this duty:

### 5.2 *To act prudently:*

- Exercise the "care, skill and diligence" a prudent person would exercise, not just when dealing with their own investments, but when dealing with investments for someone else for whom they feel morally bound to provide.
- Apply special knowledge and experience they possess or, if they are professional trustees, the skills expected of a professional trustee.
- Have regard to the need for diversification of investments, in so far as appropriate to the circumstances of the Scheme's regulations.
- Have regard to the suitability of each investment.
- Obtain and consider "proper advice" on certain matters, such as whether an investment complies with the Statement of Investment Principles required for occupational pension schemes.
- Take account for all relevant considerations and ignore irrelevant considerations.
- Act reasonably.

### 5.3 *To act for a proper purpose:*

- Trustees must also exercise their investment powers for a proper purpose, i.e. the purpose for which the Scheme was established.

5.4 In the case of the Pension Fund, the "proper purpose" is ultimately to pay future pension promises to its members, and therefore obtain sufficient returns with which to do so, as set out in the Fund's SIP (Section 7: Investment Objective):

*“The Fund invests monies received which are not immediately required to pay benefits. The long-term objective of this “pool” of investments is to have sufficient money available to meet future liabilities, in the form of benefits to its members, and at the same time to minimise the contribution payable by the Scheme employers.”*

5.5 In other words, the investment objective is to provide returns over the long term to ensure there are sufficient resources available to meet the Fund’s actuarially calculated liabilities and achieve full funding (i.e. no funding deficit). This overriding principle of providing returns for beneficiaries has been subject to notable legal cases:

5.5.1 ***Cowan v. Scargill (1984):***

The court held that the purpose of a pension’s trust is to provide financial benefits; powers of investment under the trust must be exercised ‘*so as to yield the best return for the beneficiaries*’, taking into account risks of the investment in question. In considering what investments to make, in his view, the judge maintained that trustees must put their own personal interests to one side and simply adopt the most ‘*beneficial*’ investment.

This decision has since been interpreted by some members of the investment community as imposing a duty to obtain the maximum rate of return as possible, effectively precluding trustees and their fund managers and advisors from having regard to any considerations, other than the maximisation of financial returns. This decision predates the provisions of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009.

5.5.2 ***Martin v. City of Edinburgh District Council (1988):***

A similar issue arose where the Council divested from South Africa without expressly considering whether it was in the best interests of the beneficiaries, and without obtaining professional advice. However, the judge expressed the view that trustees did not have an unqualified duty to ‘*rubber stamp*’ investment manager’s advice or to invest funds in the most profitable investment available.

5.5.3 ***Harries v. Church Commissioners (1992):***

This case is relevant as the court held that excluding investments in certain business activities on ethical grounds could be acceptable where an adequate investment remains, but trustees should not take into account such non-financial considerations to an extent which would give rise to risk of significant financial detriment to the proper object of the trusts.

## 6. RELEVANT REGULATIONS

6.1 In addition to case law, fiduciary duties relating to the Pension Fund are enshrined in the relevant regulations and affect such investments as detailed below:

## 6.2 ***The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378)***

### 6.2.1 The relevant parts of the regulations are:

- Regulation 2 (3) (b) (vi) requires Statement of Investment Principles to include the extent (if at all) which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments.
- Regulation 4 (2) (a) states that assets must be invested in the best interests of members and beneficiaries.
- Regulation 4 (2) (b) provides that, in the case of a potential conflict of interest, the asset must be invested in the sole interest of members and beneficiaries.
- Regulation 4 (3) requires that the powers of investment, or the discretion, must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole.
- Regulation 4 (7) states that the assets of the scheme must be properly diversified in such a way as 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 assets issued by the same issuer or by issuers belonging to the same group must not expose the scheme to excessive risk of concentration.

## 6.3 ***The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 (SI 2009/3093) in relation to social, environmental and ethical considerations within Statement of Investment Principles:***

### 6.3.1 The relevant parts of the regulations are:

- Regulation 11 requires an administering authority to formulate a policy for the investment of its fund money, with a view
  - to the advisability of investing fund money in a wide variety of investments, and
  - to the suitability of particular investments and types of investments.
- Regulation 12 states that an administering authority must, after consultation with such persons as it considers appropriate, prepare, maintain and publish a written statement of the principles governing its decisions about the investment of fund money, and then goes on to repeat the provisions of the Occupational Pension Schemes (Investment) Regulations 2005 2 (3) (b) (vi) referred to above.

## 6.4 In issuing these regulations, the Government did not seek to impose requirements regarding ethical investment, but instead impose a requirement on administering authorities to include in their SIP their policy on:

*“the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments.”*

## 6.5 Whilst there is no requirement to take into account social, environmental or ethical considerations, the Teesside Pension Fund sets out its position via the SIP (Section 9), which is similar to that taken by the majority of LGPS funds.

## 7. LAW COMMISSION REPORT (LAW COM NO. 350)

7.1 The Law Commission was asked to consider how the law of fiduciary duties applies to investment intermediaries. The project arose out of the Kay Review, published in July 2012. This Review set out ten principles for the UK equity market. Principle 5 was that “*all participants in the equity investment chain should observe fiduciary standards in their relationships with their clients and customers*”. Recommendation 9 said that:

*“The Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers.”*

7.2 The project was commissioned and the Law Commission were asked to do five things:

- 1) To investigate how fiduciary duties currently apply to investment intermediaries and those who provide advice and services to them.
- 2) To clarify how far those who invest on behalf of others may take account of factors such as social and environmental impact and ethical standards.
- 3) To consult relevant stakeholders.
- 4) To evaluate whether fiduciary duties (as established in law or as applied in practice) are conducive to investment strategies in the best interests of the ultimate beneficiaries.
- 5) To identify areas where changes are needed.

7.3 The Law Commission published a consultation paper in October 2013, received 96 responses and was ordered by the House of Commons to print their report on 30 June 2014. The full report is available at <http://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/>.

7.4 The report specifically considers the Local Government Pension Scheme in Section 7, paragraph 7.86 to 7.88, with the following recommendation (paragraph 7.95):

*We recommend that the Government should review two aspects of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009. These are:*

- 1) Whether the Regulations should transpose article 18 (1) of the IORP Directive; and*
- 2) Those aspects of regulation 9 which require investment managers to be appointed on a short term basis and reviewed at least every three months.*

7.5 The first recommendation seeks to ensure there is a specific requirement in the LGPS regulations to invest scheme assets in the best interests of scheme members. This requirement, in contrast to private sector occupational pension schemes, has not been transposed into law for LGPS funds. Article 18 (1) on investment rules of the Institutions for Occupational Retirement Provision (IORP) Directive 2003/41/EC states:

*“Member States shall require institutions located in their territories to invest in accordance with the ‘prudent person’ rule and in particular in accordance with the following rules:*

- a) The assets shall be invested in the best interests of members and beneficiaries. In the case of a potential conflict of interest, the institution, or the entity which manages its portfolio, shall ensure that the investment is made in the sole interest of members and beneficiaries.*
- b) The assets shall be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole. Assets held to cover the technical provisions shall also be invested in a manner appropriate to the nature and duration of the expected future retirement benefits.*
- c) The assets shall be predominantly invested on regulated markets. Investments in assets which are not admitted to trading on a regulated financial market must in any event be kept to prudent levels.*
- d) Investments in derivative instruments shall be possible insofar as they contribute to a reduction of investment risks or facilitate efficient portfolio management. They must be valued on a prudent basis, taking into account the underlying asset, and included in the valuation of the institution’s assets. The institution shall also avoid excessive risk exposure to a single counterparty and to other derivative operations.*
- e) The assets shall be properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings and accumulations of risk in the portfolio as a whole. Investments in assets issued by the same issuer or by issuers belonging to the same group shall not expose the institution to excessive risk concentration.*
- f) Investment in the sponsoring undertaking shall be no more than 5% of the portfolio as a whole and, when the sponsoring undertaking belongs to a group, investment in the undertakings belonging to the same group shall be no more than 10% of the portfolio.”*

7.6 The second recommendation is a criticism of short termism in some funds who review the performance of investment managers quarterly and as part of the performance review consider re-appointment.

7.7 The other part of the Report which affects LGPS funds, and is pertinent to this report, is the guidance from the Law Commission on pension trustees' duties when setting an investment strategy. This considers Professor Kay's concerns that:

*"Some pension fund trustees equated their fiduciary responsibilities with a narrow interpretation of the interests of their beneficiaries which are focused on maximising financial returns over a short timescale and prevented the consideration of longer term factors which might impact on company performance, including questions of sustainability or environmental and social impact."*

7.8 The Law Commission's conclusion was that trustees must always take account of financial factors when making investments, securing the best realistic return over the long term, given the need to control risks.

7.9 Trustees may also take into account non-financial factors, BUT only if two test are met:

- 1) Trustees have good reason to think that scheme members would share their concern; and
- 2) The decision does not involve a risk of significant financial detriment to the fund.

## **8. LOCAL GOVERNMENT ASSOCIATION (LGA) – QC ADVICE**

8.1 The LGA, by way of seeking further clarification in this matter, asked for Queens Counsel's advice on the nature of the duties which fall upon the administering authorities of funds established for the purpose of the Local Government Pension Scheme (LGPS). Nigel Giffen QC reported his opinion in March 2014, with the following conclusions:

8.1.1 In managing an LGPS fund, the administering authority has both fiduciary duties and public law duties (which are in practice likely to come to much the same thing).

8.1.2 The administering authority's power of investment must be exercised for investment purposes, and not for any wider purposes. Investment decisions must therefore be directed towards achieving a wide variety of suitable investments, and to what is best for the financial position of the fund (balancing risk and return in the normal way).

8.1.3 However, so long as that remains true, the precise choice of investments may be influenced by the wider social, ethical or environmental considerations, so long as that does not risk material financial detriment to the fund. In taking account of any such considerations, the administering authority may not prefer its own particular interests to those of other scheme employers, and should not seek to impose its particular views



where those would not be widely shared by scheme employers and members (nor may scheme employers impose their views upon the administering authority).

- 8.2 In essence, this advice reiterates the pertinent parts of the Law Commission report, case law and statutory regulations, and puts them into context for the LGPS. The advice also clearly states that, in managing an LGPS fund, the administering authority has fiduciary duties. It is for this reason, it is said Investment Panel Members are “quasi-trustees”.

## **9. DRAFT INVESTMENT REGULATIONS 2016 AND CONSULTATION**

- 9.1 The draft investment regulations (The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016) and current outstanding consultation (Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009) complies with the recommendations of the Law Commission report. The 2009 investment regulations included restriction on investments, particularly on the amount LGPS funds could invest in different asset types. The draft 2016 regulations ask LGPS funds to create their own criteria in accordance with the “prudent person” rule.

- 9.2 In addition, the draft 2016 regulations remove the requirement for a SIP and ask for this to be replaced with an Investment Strategy Statement. The Investment Strategy Statement which must cover:

- The requirement to use a wide variety of investments (diversification).
- The Fund’s assessment of the suitability of particular investment and types of investments.
- The Fund’s approach to risk, including how it will be measured and managed.
- The Fund’s approach to collaborative investment, including the use of collective investment vehicles and shared services.
- The Fund’s environmental, social and corporate governance policy.
- The Fund’s policy on the exercise of rights, including voting rights, attached to its investments.

- 9.3 In the consultation, paragraphs 3.7 & 3.8 (below) indicates that further clarity will be published as to the Secretary of State for Communities and Local Government position on non-financial factors with LGPS investments:

### *“Non-financial factors*

*3.7 The Secretary of State has made clear that using pensions and procurement policies to pursue boycotts, divestments and sanctions against foreign nations and the UK defence industry are inappropriate, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government. The Secretary of State has said, “Divisive policies undermine good community relations,*

*and harm the economic security of families by pushing up council tax. We need to challenge and prevent the politics of division.”*

*3.8 The Local Government Pension Scheme (Management and Investment of Funds)*

*Regulations 2009 already require administering authorities to publish and follow a statement of investment principles, which must comply with guidance issued by the Secretary of State. The draft replacement Regulations include provision for administering authorities to publish their policies on the extent to which environmental, social and corporate governance matters are taken into account in the selection, retention and realisation of investments. Guidance on how these policies should reflect foreign policy and related issues will be published ahead of the new Regulations coming into force. This will make clear to authorities that in formulating these policies their predominant concern should be the pursuit of a financial return on their investments, including over the longer term, and that, reflecting the position set out in the paragraph above, they should not pursue policies which run contrary to UK foreign policy.”*

- 9.4 The new regulations are due to come into effect on 1 April 2016, with a transition period of six months for LGPS funds to produce and approve their Investment Strategy Statements. The guidance referred to and needed to produce an environmental, social and corporate governance policy which reflects foreign policy and complies with the predominant concern of a financial return on investments should be provided before the end of the transition period.

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