



Response to Draft OECD Guidelines for Pension Fund Governance

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1. About FairPensions

FairPensions is pleased to have this opportunity to comment on the “*Draft OECD Guidelines For Pension Fund Governance*” which have been put out for consultation by the OECD's Directorate for Financial and Enterprise Affairs (“*the Guidelines*”).¹

FairPensions is a project of the Fairshare Educational Foundation, a UK registered charity established to promote Responsible Investment (“*RI*”) by pension schemes². We define RI as ***the integration of environmental, social and governance (“ESG”) considerations into investment policy***. For this purpose, investment policy includes ***engagement with investee companies*** i.e. shareholder activism through dialogue, reinforced by the potential exercise of shareholder powers.

Integral to our campaign for RI is our demand for greater ***transparency*** on the part of occupational pension scheme trustees³ in reporting to their beneficiaries on their RI policies and on the implementation of these policies. Such transparency is essential for the following reasons: firstly, scheme members should know what action is being taken on their behalf in relation to ESG issues, so that, if necessary, they can exert pressure on their trustees to improve their performance; secondly, full reporting on ESG questions encourages scheme trustees to compare their standards of disclosure against best practice among their peers; thirdly, the wider interests of society, which lie in the promotion of RI, are thereby served.

We also wish to see equivalent transparency in relation to contract-based personal pension arrangements.

One of the ways in which we seek to further these objectives is ***to urge scheme trustees, fund managers and investment consultants to adopt the United Nations Principles for Responsible Investment (“UNPRI”)***, drawn up under the United Nations Environment Programme Finance Initiative (*UNEP FI*). The principles can be found at:

www.unpri.org/principles/

FairPensions is supported by the following organisations: ActionAid, Amnesty International, Cafod, CWU, Community, ECCR, EIRIS, GMB, NUJ, Oxfam, Traidcraft, Unison, Unite and WWF. We also count thousands of individual pension fund members as our supporters.

Further information about FairPensions and about our approach to RI can be found on our website.⁴

2. Scope of this Response

This Response is confined to those aspects of the Guidelines that relate to RI. We would, however, emphasise that ***some of the points made in the Response apply with equal force to the improvement of all aspects of corporate governance through active share ownership***. Indeed, there is an overlap: for example, the concern of responsible investors that corporate policy be aligned with the long-term interests of shareholders has obvious

¹ In this Response, references to a Guideline include the Annotations to that Guideline.

² Fairshare Educational Foundation is UK registered charity 1117244

³ We are usually concerned with UK occupational schemes, which are typically trust-based.

⁴ www.fairpensions.org

implications for executive remuneration, as where compensation is structured so as to reward short-term profits rather than sustainable ones.

This Response covers (i) the financial and legal reasons for pension funds to pursue RI policies, (ii) the public interest dimension of RI, in relation both to the economy and to the environment and (iii) our comments on the Guidelines together with the amendments which we believe are needed in order that the Guidelines give due recognition to RI.

3. The Financial and Legal Case for RI

Institutional investors increasingly recognize that RI policies can contribute to financial return. The growing number of asset owners, investment managers and investment consultants who subscribe to the UNPRI is evidence of the emerging consensus about the financial importance of ESG factors.⁵ As the introduction to the UNPRI puts it:

“As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social and corporate governance (ESG) issues can affect the performance of investment portfolios”.

Recent research also supports the view that shareholder engagement can increase investment returns beyond traditional benchmarks. We would refer, for example, to the review of key academic and broker research on ESG factors which was co-authored by the Asset Management Working Group of UNEP FI and Mercer.⁶ The review included four academic studies of shareholder activism on governance issues; of these, three found a positive effect on investment return, the fourth being neutral.

One of these studies is particularly noteworthy: it examined activism by CalPERS (California Public Employees Retirement System), the largest public pension plan in the US and a leading activist fund. The study concluded that, over the period under review, the value increase of CalPERS' holdings from activism was almost US\$19m, compared to estimated costs of activism of approximately US\$3.5m.⁷

In parallel with the new thinking on this subject within the investment community, ***there has been an increased acceptance among lawyers that pension funds should take ESG considerations into account when determining investment policies.*** For example, the international law firm Freshfields Bruckhaus Deringer produced a report⁸ for UNEP FI on the law in nine separate jurisdictions⁹ regarding the integration of ESG issues into investment policy. The report concluded that

*“...the links between ESG factors and financial performance are increasingly being recognised. On that basis, 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”.*¹⁰

⁵ See the list of signatories at www.unpri.org/signatories/

⁶ “Demystifying Responsible Investment Performance: A review of key academic and broker research on ESG factors” UNEP FI / Mercer, 2007
www.unepfi.org/fileadmin/documents/Demystifying_Responsible_Investment_Performance_01.pdf.

⁷ *ibid*, p.32

⁸ Freshfields Bruckhaus Deringer “A legal framework for the integration of environmental, social and governance issues into institutional investment”, 2005 (www.unepfi.org/fileadmin/documents/freshfields_legal_resp_2005123.pdf).

⁹ namely, Australia, Canada, France, Germany, Italy, Japan, Spain, the UK, and the US.

¹⁰ Freshfields Bruckhaus Deringer *op cit* p.13

As well as this financial significance of ESG factors, the report considered the question of whether pension schemes should take into account their beneficiaries' non-financial concerns over ESG issues, provided this did not prejudice investment performance; it concluded that

*“It is also arguable that ESG considerations must be integrated into an investment decision where a consensus (express or in certain circumstances implied) among the beneficiaries mandates a particular investment strategy and may be integrated into an investment decision where a decision-maker is required to decide between a number of value-neutral alternatives”.*¹¹

4. The Public Interest Case for RI Engagement

Once it is accepted that RI can increase long-term financial returns, it is clearly in the interests of pension scheme beneficiaries for their funds to practise RI. It also follows that there is a broader public interest involved: if RI contributes to the more efficient allocation and use of investment capital, it is of benefit to the wider economy, whether national or global.

There is, however, an even more important public interest dimension to RI. Socially irresponsible corporate behaviour is one of the main sources of the environmental problems threatening the global economy and society. ***The promotion of corporate social responsibility by institutional investors should therefore be a public policy imperative not only in the economic but also in the environmental sphere.***

Perhaps the most obvious example of the environmental significance of corporate behaviour is its causal role in climate change, a threat which the Secretary-General of the OECD recently described as *“the defining issue of our time”*¹². There is growing awareness among institutional investors that climate change has become a fiduciary issue.¹³ One manifestation of this is the Institutional Investors Group on Climate Change, whose membership now comprises European pension funds and other investors with aggregate assets under management of some four trillion euro. The IIGCC has pointed out that

*“institutional investors have a critical role to play in supporting the move to a low carbon economy through using their influence as major shareholders and bondholders in the world's companies and as substantial investors in other assets such as property as well as using their influence with policymakers”*¹⁴

As the above statement indicates, there is a twofold aspect to the development of RI: although much depends upon the initiatives taken by investors, ***there is also a need for governments to provide a legal and regulatory framework which encourages and supports RI.***

5. Comments on the Guidelines

¹¹ *Ibid*

¹² Remarks by Angel Gurría at Chatham House Conference, 30 June 2008 (OECD website)

¹³ See, for example, *“A Climate for Change”* (2005), produced by Mercer Investment Consulting for the Institutional Investors Group on Climate Change and the Carbon Trust (www.iigcc.org)

¹⁴ *“Investor Statement on Climate Change Report 2007”* p.7, (www.iigcc.org)

(1) As already stated, our comments on the Guidelines relate only to RI. We would, however, make the general comment that, in our view, the Guidelines appear to cover all the key areas of pension scheme governance, other than RI and active share ownership.

(2) The only mention of RI in the Guidelines is in the Annotation to Paragraph 11 (Disclosure). This refers to information that plan members and beneficiaries should receive in accordance with the OECD Guidelines for the Protection of the Rights of Members and Beneficiaries and adds

“The governing body may also wish to disclose if, and if so how, environmental, social, and governance considerations are taken into account in the investment policy”.

We consider that this recommendation is too weakly worded and falls below the standard already set by law or best practice in many jurisdictions. In the UK, for example, pension scheme trustees have been required by law since 2000 to disclose in their Statements of Investment Principles

“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...their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to the investments”¹⁵

We would suggest, therefore, that, as a minimum, the recommendation should be worded on the following lines:

“The governing body should also disclose their policy in relation to the integration of environmental, social and governance (“ESG”) considerations into:

****the investment policy; and***

****the policy in relation to the exercise of rights (including voting rights) attaching to investments.***

There should also be full disclosure of the manner in which any such policy in relation to ESG considerations has been implemented during the reporting period in question, including, where relevant, details of voting records in respect of investments.”

The above wording reflects the fact that the governing body has no choice but to have policies in relation to the integration of ESG factors and in relation to the exercise of shareholder rights, even if it believes that it can somehow justify a policy of ignoring these considerations. Moreover, the final sentence is consistent with the point made in the OECD Guidelines for the Protection of the Rights of Members and Beneficiaries that

“Adequate disclosure, in addition to helping to effectuate the substantive and procedural rights of members and beneficiaries, may also lead to more effective pension plan governance by enabling members to monitor certain aspects of plan administration”¹⁶

We think that this principle is especially relevant to the disclosure of voting records and of other engagement activities: such information is not of a highly technical nature and can

¹⁵ Regulations 2(3)(b)(vi) and 2(3)(c) of The Occupational Pension Schemes (Investment) Regulations 2005 (Statutory Instrument 2005 / 3378). (Some categories of pension scheme are exempt from this requirement.)

¹⁶ Page 12

therefore be easily understood by beneficiaries; at the same time, unless specific details are supplied, beneficiaries cannot check that the engagement policy has been observed.

We appreciate that the Guidelines for the Protection of the Rights of Members and Beneficiaries are not currently up for consultation but we would respectfully suggest that at least Part IV of those Guidelines (Disclosure and availability of information) be reviewed in this connection, both with regard to what information should be given to plan members and beneficiaries and with regard to how such information is to be communicated. This review should cover both occupational and personal pension arrangements. We should welcome the opportunity to contribute to any related consultation.

(3) Several of the Guidelines have potential relevance to RI ***but in most cases their effectiveness will depend upon the governing body having already adopted an RI policy***, or at least being aware of RI as an issue. For example, Guideline 3 (Delegation and expert advice) should be read as requiring that investment consultants and fund managers have the requisite expertise to advise on, or to implement, an RI policy. Likewise, in the case of Guideline 9 (Risk-based internal controls), the recommendation that there be external reviews of the performance of the governing body should cover their standards of reporting to beneficiaries on, for example, engagement policies, while the recommendation of evaluations of external fund managers should equally include their track record on RI. For this reason, ***it is important that the Guidelines give sufficient prominence to RI, so that awareness of the issue feeds through into the general provisions on fund governance.***

(4) We would single out one other provision in the Guidelines which we believe has particular importance to RI.. This is the observation in Guideline 7 (Accountability) that ***accountability to plan members and beneficiaries can be enhanced by requiring their representation on the governing body.*** We strongly agree with this. So far as RI is concerned, the presence of such representatives should help ensure that due weight is given to members' views on, for example, any ethical criteria that should inform investment or engagement policies (within the limits of fiduciary duties). It should also make it more likely that reporting to members on the implementation of RI policies is at once specific and comprehensible. ***We would suggest that the Guidelines be strengthened so as to recommend that, as a norm, member and / or beneficiary representatives constitute at least one half of the governing body.***

(5) In addition to the amendments to the Guidelines suggested above, we suggest ***that the OECD take the further step of explicitly recommending that pension funds should either subscribe to the UNPRI or explain to their members why they have decided not to do so.*** We have outlined above the economic and environmental public benefit case for governmental encouragement of RI, and in the UNPRI there already exists an internationally recognised code of conduct that meets that objective. Adherence to the UNPRI would not fetter the fiduciary discretion of the governing bodies of pension funds, as the principles are voluntary and operate only on a “*comply or explain*” basis.

As it would be confusing and counter-productive to have competing sets of principles drawn up by different international organisations, we would urge the OECD to adopt the UNPRI rather than to formulate its own alternative.

We believe that such an initiative by so influential a body as the OECD would be a highly significant contribution to economic and environmental sustainability.