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19<sup>th</sup> December 2008

Ms Kate Gerrard  
The Regulated Community Learning Team  
The Pensions Regulator  
Napier House  
Brighton BN1 4DW  
Email: [kate.gerrard@thepensionsregulator.gov.uk](mailto:kate.gerrard@thepensionsregulator.gov.uk)

Dear Ms Gerrard,

**Response of FairPensions to the Pensions Regulator  
Consultation on Refreshed TKU Code of Practice and Scope Guidance**

FairPensions is pleased to have this opportunity to respond to the consultation document. We are a registered charity focused on the promotion of responsible investment by institutional investors, particularly pension funds and the fund managers who serve them. We focus on encouraging good governance, transparency and accountability throughout the investment chain. Our work is informed by the view that responsible and engaged ownership of assets by pension fund trustees delivers stronger returns for beneficiaries over the long term. Furthermore responsible ownership leads to responsible corporate behaviour, which given the universal ownership profile of many funded pension schemes, is also likely to be in the best interest of members, and indeed of society more broadly.

Whilst this response is prepared on behalf of FairPensions, it is informed by my experience over the last year as a Member Nominated Trustee at The Pensions Trust, a multi-employer pension fund with 129,000 DB and DC members in the UK's charitable, social, educational and not-for-profit sectors. I was elected last December and have served on the board since April 2008. Since that time, I have completed the Regulator's Trustee Toolkit and passed the PMI's Award in Trusteeship. In my personal experience both the Regulator's Toolkit and the PMI's examination are well designed and essential for getting on top of the required TKU. It is reasonable to expect all trustees to achieve this much.

## **Comment on the ‘Introduction to the Consultation Document’**

The financial crisis of 2008 has amply demonstrated the risks for individuals and society as a whole that arise from a financial system where there is ineffective regulatory scrutiny. Members of pension schemes are not as vocal as people working in the industry, but beneficiaries need a Pensions Regulator that is an obviously recognised champion of their interests.

The first two pages of the consultation document imply at several points a bias for deregulation on the part of the regulator. Despite consistent pressure for deregulation from parts of the pensions industry, including from some trustees, pensions regulation, not least the TKU regime, exists to protect members and must be robustly defended. Members’ financial future depends upon conscientious, knowledgeable and effective decision making by trustees and by agents with delegated powers.

## **Knowledge and Understanding of Responsible Ownership Rights and Responsibilities**

The Code of Practice on TKU aims to provide practical guidance on the requirements of pensions legislation. It is a requirement of Statutory Instrument 2005 No 3378 that trustees must state in their Statement 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.’

In practice, **trustees cannot disclose what consideration they give, if any, to ‘extra-financial’ factors in the investment process without a proper understanding of why and in what circumstances such considerations could have a material impact upon investment performance.** TKU guidance should assist trustees in gaining this necessary understanding and in keeping up to date with relevant developments.

As is reflected in the Regulator’s *Guidance to Trustees* (page 33), before preparing or revising their Statement of Investment Principles trustees are further required by SI 2005 No 3378 “to obtain and consider the written advice of a person who is reasonably believed by the trustees to be qualified by his ability in and practical experience of financial matters to have the appropriate knowledge and experience of the investments of such schemes”. Because trustees have to decide their positions on social, environmental and ethical considerations and on the exercise of shareholder rights in order to draw up their SIP, they should satisfy themselves that their chosen advisor has “appropriate knowledge and experience” of these matters. The TKU guidance should make this clear.

Evidence of the material impact of environmental, social and governance factors on the financial success of companies is increasing. For example, Mercer’s 2007 report entitled *Demystifying Responsible Investment*

*Performance* cites detailed academic and industry studies that show a positive association between the inclusion of ESG criteria and enhanced financial performance. The report is available at:

[http://www.unepfi.org/fileadmin/documents/Demystifying\\_Responsible\\_Investment\\_Performance\\_01.pdf](http://www.unepfi.org/fileadmin/documents/Demystifying_Responsible_Investment_Performance_01.pdf)

In the two years since the last Code of Practice and Scope Guidance was issued, there has been considerable advance both in the UK and internationally in the field of responsible investment. A major factor in this has been the global success of the United Nations Principles for Responsible Investment (UNPRI) to which thirteen of the largest UK pension funds have become signatories. These UK funds along with the more than 100 international pension funds which have adopted the Principles over the last 3 years support the premise that integrating environmental, social and governance (ESG) issues into investment decision-making and ownership practices will improve long-term returns. These funds' support for responsible investment springs from their understanding of fiduciary obligation. Details of UNPRI can be found at: <http://www.unpri.org/>

In 2005, the UNEP Finance Initiative commissioned from law firm Freshfields Bruckhaus Deringer a study entitled, "A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment". A full copy of the report can be found at:

[http://www.fairpensions.org.uk/pdf/freshfields\\_legal\\_resp\\_20051123.pdf](http://www.fairpensions.org.uk/pdf/freshfields_legal_resp_20051123.pdf). The analysis of fiduciary obligation developed in the report is as follows:

"It is not a breach of fiduciary duties per se to have regard to ESG considerations whilst pursuing the purposes of the trust. Rather, in our opinion, it may be a breach of fiduciary duties to fail to take account of ESG considerations that are relevant and to give them appropriate weight, bearing in mind that some important economic analysts and leading financial institutions are satisfied that a strong link between good ESG performance and good financial performance exists."

**The existence and international influence of this legal opinion on fiduciary duty has changed the context in which UK trustees make decisions.** If, as stated, it may be a breach of fiduciary duties for trustees to ignore material ESG considerations, they must clearly understand the implications if their fund managers are not explicitly mandated to integrate ESG considerations into the investment process. It is possible that in the future, for example in DC schemes where investment returns turn out to be poor, scheme beneficiaries could challenge (legally or otherwise) trustees who were poorly informed, or even willfully dismissive, of considerations which have a material impact on long-term investment returns.

In this context it is important for the guidance on the scope of the TKU requirements to properly encourage trustees to understand both the material risks to investment returns which can be associated with companies' handling of extra financial factors, and the risk to trustees themselves if they inadvertently act in breach of

their own fiduciary duties by ignoring these factors in the investment process.

Having recently completed the Trustee Toolkit, my view is that this otherwise excellent educational resource does not adequately assist trustees in understanding material risks and considerations in this area. The proposed new Scope Guidance on TKU requirements does not move trustees forward in this important area. Indeed, the proposed wording of Unit 11 is, if anything, weaker than the Unit 11 wording of the 2005 Scope Guidance. Unless this wording is clarified to take on board substantial and relevant changes in the investment decision making context arising not only from the Freshfields legal opinion for but also from the new best practice guidance on the updated Myners Principles (Principle 5), trustees risk being misled by the TKU guidance in relation to their legal responsibilities.

There is a further point that relates specifically to the taking into account of *ethical* considerations in investment decisions. Quite apart from the financial case for integrating ESG factors into the investment process, it is now generally accepted that trustees may properly take into account what they reasonably believe are the ethical values of beneficiaries on particular issues, provided this can be done without financial detriment to the scheme. This view was endorsed in the Freshfields Bruckhaus Deringer study referred to above. The TKU guidance should cover this aspect also, especially as the current version of the Regulator's *Guidance to Trustees* does not do so, whereas the previous version did; we think that this was a retrograde change.

### **Understanding Risks Associated with Trustees' Delegation of Powers**

FairPensions has undertaken extensive research into the capability of fund managers used by UK pension funds to effectively integrate ESG risks into the investment decision making process as well as their capacity to effectively engage with investee companies to address and mitigate these risks. Our research findings raise issues which trustees should be alert to. Whilst a growing number of fund managers put considerable time and effort into analysing and engaging companies about extra financial risks, a majority of fund managers continue to have poor competence in this area. Our most recent analysis can be found in our 2008 report, 'Investor Responsibility?' -

[http://www.fairpensions.org.uk/fairpensions\\_pdf/FundManagerRanking08.pdf](http://www.fairpensions.org.uk/fairpensions_pdf/FundManagerRanking08.pdf)

It is for this reason that trustees need to be very alert when they delegate powers and duties that relate to their core fiduciary duties to members. Trustees who write into their Statement of Investment Principles that, where material, they require consideration to be given to social, environmental or ethical considerations in the selection, retention and realisation of investments, must take all reasonable steps to satisfy themselves that investment managers have the appropriate knowledge and experience to implement this policy and that, once appointed, they are doing so competently. The same principle applies where the SIP includes a policy

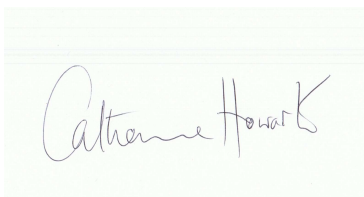
of engagement in investee companies. The TKU guidance should encourage trustees to scrutinise and monitor managers to whom investment decision making has been delegated. Under section 34 of the Pensions Act 1995, if trustees fail to do this, they may remain responsible if managers fail to effectively implement the SIP to the detriment of scheme beneficiaries.

## **Conclusions**

The TKU regime has played a very significant role in raising the quality of trustee decision making. Deservedly, the TKU requirements have earned considerable credibility within and beyond the pensions industry. It is for this reason that FairPensions believes it is critically important for TKU to reflect important developments in the field of responsible investment which have a bearing on how members and trustees themselves are coming to understand and interpret fiduciary duties.

We would be pleased to comment and assist further in any way with the development of a form of wording for the TKU Code of Practice and Scope Guidance which addresses the risks to members and trustees raised in this submission.

Yours sincerely,

A handwritten signature in cursive script, reading "Catherine Howarth", is displayed on a light green rectangular background.

Catherine Howarth  
Executive Director