Sackers

Finance & investment briefing

September 2022

Sackers finance & investment group takes a look at current issues of interest to pension scheme investors

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Abbreviations

CMA: Competition and Markets Authority

DB: Defined Benefit

DC: Defined Contribution

DWP: Department for Work and Pensions

ESG: Environmental, social and corporate governance

IGC: Independent Governance Committee

LDI: Liability-driven investment

OTC: Over the counter

SIP: Statement of Investment Principles

TPR: The Pensions Regulator

TSF: Taskforce on social factors

Finance & investment focus

"I hope that you have had an enjoyable summer and are refreshed ahead of what promises to be a busy autumn for the pensions industry.

It has been an unusually hot and dry couple of months and perhaps the recent heatwaves provide the most obvious segue into our third finance & investment briefing of 2022, given that ESG continues to be the key theme. On pages 3 – 4 we reflect on two new high court cases that have considered the extent to which ESG is a financial factor and examine what this means for decision making by pension trustees.

We also catch up on the latest developments in the recent DWP consultations on trustees' oversight of investment consultants and fiduciary management, together with changes to climate and investment reporting.

If you have any questions about the issues raised please speak to your usual Sackers contact."

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ESG – a financial factor? A spotlight on recent judgments

Reflecting the rise of ESG issues for investors, two recent High Court cases have raised interesting issues for trustees around climate-related investment decisions.

Butler-Sloss v The Charity Commission for England and Wales

In *Butler-Sloss v The Charity Commission for England and Wales*, the High Court was asked to consider whether two charitable trusts could adopt a proposed investment policy ("the Policy") which excluded potential investments which conflicted with the trusts' charitable purposes of environmental protection, even if financial returns would suffer as a result.

The Policy was aligned with the Paris Agreement on Climate Change and led to the exclusion of over 20% of the investible universe, on the basis that it did not meet the trusts' charitable purposes. The trustees accepted that they were unable to conclude the extent of the potential financial detriment that might result from the Policy.

The judge held that this was a matter for the trustees' discretion in exercising their powers of investment. While he cautioned against trustees making investment decisions on purely moral grounds, the key question here was whether the trustees had properly carried out a balancing exercise between the trusts' charitable purposes and their financial performance when deciding to adopt the Policy. If that balancing exercise was properly done and a reasonable investment policy then adopted, the trustees would have complied with their duties, even if the court or another trustee might have reached a different conclusion.

The judge found that the trustees had undertaken that exercise properly here. They had carefully considered the content and effect of the Policy, with the benefit of professional advice, and so implementing the Policy would discharge their duties regarding the proper exercise of their investment powers.

McGaughey v Universities Superannuation Scheme Ltd

On the other hand, the recent decision in *McGaughey v Universities Superannuation Scheme Ltd* demonstrates the difficulties faced by pension scheme members in challenging investment decisions if they consider that they do not go far enough on ESG issues.

Two university lecturers issued proceedings against a number of current and former directors of USS Ltd ("USS"), the corporate trustee of the Universities Superannuation Scheme, seeking a declaration that the fund did not have a plan in place for immediate divestment from fossil fuels, breaching the directors' duties to the trustee company.

In order to succeed, the members had to show that the directors of USS had committed a deliberate or dishonest breach of duty or had improperly benefited themselves at the expense of USS.

The members relied on various articles and studies as evidence that fossil fuels have performed badly since 2017 while renewables have consistently performed better. They therefore argued that USS' failure to implement a plan to immediately divest from fossil fuels had caused it to suffer loss.

In response, USS provided evidence of its investment decision-making, including that it had made changes to more than £5bn of assets under management where it considered this to be financially advantageous to the scheme, while putting in place policies to engage with its ongoing fossil fuel investments to encourage a transition towards carbon neutrality.

The judge dismissed the claim as there was no evidence that USS or the claimants had or would suffer loss as a result of the divestment strategy, or that there had been any deliberate or dishonest breach of duty by the directors in adopting that strategy. USS' evidence showed that it had acted well within the scope of its discretion in exercising its powers of investment.

ESG – a financial factor? A spotlight on recent judgments cont.

What do these cases mean for pension trustees?

The judgments together reflect that, while trustees should not be making investment decisions on purely moral grounds, ESG can and should be considered where it is a financial factor. The *Butler-Sloss* case makes clear that, for charitable trustees, the objects of the charity will also be relevant and can be taken into account by trustees when exercising their investment powers, although this will be of limited relevance to trustees of pension schemes.

As long as they act within the scope of their discretion, and in accordance with their investment powers, trustees will be acting properly and their decisions will withstand challenge. This will be of comfort to trustees as ESG issues become increasingly significant.

It is important for trustees to keep records of their decisions and reasons to demonstrate, if necessary, how and why they have exercised their discretion. In the *Butler-Sloss* case there were no formal minutes recording the decision to implement the Policy. While this was not fatal, the judge noted that they ideally should have produced these. Likewise, in the *USS* case, the trustee's evidence regarding how and why it had exercised its discretion was key.

The decisions demonstrate that climate-related risks are not simple issues. The "climate-friendliness" of individual investments is hard to measure and divestment is not the only way to mitigate climate risks. As shown in the *Butler-Sloss* case, engaging as a shareholder with companies the scheme is invested in can be an alternative solution. In both cases, extensive professional advice underpinned the trustees' decisions, showing the importance of involving professional expertise on these complex issues.

The *USS* case also demonstrates the importance of good communication and engagement with members on ESG issues. It reflects the increasing importance of non-financial factors for members and growing awareness and scrutiny around how their pension funds are being used. Similar actions may be avoided in future if members are made aware of the decisions being taken by trustees and their rationale, through (for example) surveys and regular communications.

Legal update

DWP responds to consultation on trustee oversight of investment consultants and fiduciary managers

On 6 June 2022, the DWP published its response to the 2019 consultation on draft regulations intended to integrate the CMA Order 2019 (the "Order") into pensions law. The Order requires trustees, subject to limited exceptions, to carry out a tender process for fiduciary management services and set objectives for their investment consultants (see our Alert for more detail). The regulations, which largely replicate the Order, will bring the requirements into pensions legislation and allow TPR to oversee the requirements rather than the CMA. Trustees will be required to report compliance to TPR via the scheme return process.

Following consultation, the DWP have made some minor changes to the regulations. These include changes to the definitions of "investment consultancy services" and "fiduciary management services", and to clarify which assets should be excluded from scheme assets for the purposes of identifying when the requirements apply. The regulations will come into force on 1 October 2022. TPR has also published updated guidance on 4 August 2022 reflecting this change and summarising the minor policy differences between the existing requirements and the new regulations. The update also includes new guidance on how trustees might assess the performance of potential and existing fiduciary managers. For more information, see our Alert.

DWP responds to consultation on changes to climate and investment reporting

On 17 June 2022, the DWP published its response to its October 2021 consultation (see our Alert) on proposals to require trustees of schemes in scope of the climate-related governance and reporting regulations (the "Regulations") to measure and report on the "Paris alignment" of their investment portfolios, as well as on new guidance in relation to SIPs and implementation statements.

With effect from 1 October 2022, trustees of occupational pension schemes with £1bn or more in relevant assets and authorised schemes will be required to calculate and report a metric setting out the extent to which their investments are aligned with the Paris Agreement goal of limiting global warming to well below 2°C and pursuing efforts to limit it to 1.5°C above pre-industrial levels. Where the requirement to select a portfolio metric comes into force part way through a scheme year, it will apply in the part scheme year that runs from 1 October 2022. Schemes will be able to rely on data obtained, calculations performed and identification and assessment of climate-related risks and opportunities undertaken in that same scheme year, but before 1 October 2022. The final Regulations were made on 30 June 2022 and require all schemes subject to them to measure and report on such a portfolio alignment metric in addition to the existing requirements. The statutory guidance on governance and reporting of climate change risk has been updated accordingly.

While schemes have been aware that the introduction of this new metric was on the cards, now it has been confirmed they need to ensure the necessary preparations are being made to report accordingly. As ever, time is of the essence. See our Alert for more detail.

New statutory and non-statutory guidance (the "Guidance") on reporting on stewardship in SIPs and implementation statements has also been issued. The Guidance "focuses on the areas where existing policies and reporting appear to be weakest – stewardship and, to a lesser extent, consideration of financially material ESG factors and non-financial factors". While stewardship encompasses a range of activities, the Guidance focuses specifically on voting and engagement. The Guidance concerns implementation statements that trustees are required to prepare in respect of any scheme year ending on or after 1 October 2022, meaning for a scheme with a year end of 31 December or 31 March this will affect implementation statements included in annual reports generated during the course of 2023. However, the detailed provisions included in the Guidance mean, as ever, early preparations will be key.

DWP responds to call for evidence on social risks and opportunities

On 15 July 2022, the DWP published a response to its March 2021 call for evidence seeking views on how schemes approach social risks and opportunities (see our Alert for more detail). The DWP commented that trustees who do not factor in financially material social factors are "at risk of not fulfilling their fiduciary duty". Whilst there were "strong examples of stewardship on social factors" from "a minority of respondents", the social aspects of ESG factors are an area in which the risk management of pension schemes can be strengthened.

A new taskforce on social factors ("TSF") will be established to help support trustees and the wider pensions industry with some of the challenges around these risks. The TSF will lead work to, amongst other things, identify reliable data sources and other resources which could be used by pension schemes to identify, assess and manage financially material social risks and opportunities. To help drive improvement in this area, the DWP also encourages schemes to join the Occupational Pensions Stewardship Council, and would "welcome further development" in asset managers' approach to social factors.

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Sackers is the UK's leading commercial law firm for pension scheme trustees and employers. Over sixty lawyers focus on pensions and its related areas, including Sackers finance and investment group, a team of lawyers who provide cutting edge advice to trustees, employers, corporate investors and providers on all aspects of pension scheme finance and investment.

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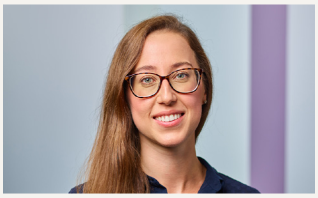

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