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**Your reference**

**Our reference**

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**By Email (drussell@uss.co.uk)**

Dear David

## **RESPONSIBLE INVESTMENT POLICY AND EXCLUSIONS**

With reference to the note from PGGM, the large Dutch Pension Fund of 1 August 2006, you have asked me to advise the Trustee Company with regard to whether the legal advice still stands which I have previously provided (both in 1998 and 1999) with regard to the legal difficulties inherent in a policy of general exclusion of certain investments or categories of investment on social, ethical and environmental grounds.

You also ask me to comment on the views set out by Freshfields on the practical relevance of the case of *Cowan v Scargill* (1984) which was one of the cases on which I based my previous advice. The views of Freshfields in this regard are set out at pages 85-100 of their report produced for the Asset Management Working Group of the UNEP Finance Initiative (October 2005).

### **1. Summary of past advice**

I attach as an appendix to this letter, the key advice which I have previously provided to the Trustee Company. In short, this was to the effect that it was incompatible with the investment duties of the Trustee Company to operate a policy of investment exclusion on the grounds (say) that a particular company was involved in arms manufacture or the manufacture of tobacco products. To do this on ethical or environmental grounds alone (without regard to the investment consequences for the fund) ran the risk of being inconsistent with the duty of the Trustee Company to invest the assets of the USS fund ("the Fund") having regard both to the need for diversification of investments, insofar as appropriate to the circumstances of the scheme and to the suitability of scheme investments both as to class and as individual investments within that class.

The main authorities on which I relied when giving that advice (which in my view still stand today) are *Cowan v Scargill* (1984) and *Bishop of Oxford v the Church Commissioners* (1991) when read with Section 36 of the Pensions Act 1995 as it then stood.

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The enclosed letter from the Chairman of USS of 16 January 1998 (which reflected fully the legal advice I had given to USS) essentially remains a correct statement of the legal position here in my view but as the investment criteria required to be taken into account under Section 36 PA 1995 changed on 30 December 2005 and in the light of the development of USS SRI policy, let me update my advice as requested.

## **2. The position under the current law**

- 2.1 The Trustee Company has both a power and a duty to invest the assets of the Scheme in accordance with the very broad investment powers conferred on the Trustee Company under USS rules. The trust law duties of the Trustee Company in this regard have not changed in that Trustee investment powers must be used solely for the purposes for which they were conferred and exercised in accordance with fiduciary care and skill in a prudent manner. USS remains a trust for the provision of financial benefits on retirement and otherwise on the termination of pensionable service. The investment powers of the Trustee Company must accordingly be exercised so as to fulfil the objective of having an investment policy which is designed to enable those financial benefits to be provided, together with the contributions made by the Institutions and the members of the scheme.
- 2.2 The statutory duty which applies under Section 36 (2) PA 1995 - as it stood when I gave my previous advice, namely that the Trustee Company had to exercise its investment powers having regard to the above requirements as to both suitability and diversification of investments still stands in substance. It has however been amplified and made more explicit in the form of a new Section 36 PA 1995 introduced on 30 December 2005 by amendment under the Pensions Act 2004 when read with certain express investment criteria which must now apply introduced under the Occupational Pension Schemes (Investment) Regulations 2005. Those amendments were made so as to bring UK domestic law into line with the requirements of the EU Pension Funds Directive (Directive 2003/41/EC). I summarise the main effect of those changes so far as relevant to the SRI matters referred to above in the following paragraphs.
- 2.3 The effect of the amended Section 36 is that the Trustee Company as the Trustee of an occupational pension scheme must exercise its investment powers in accordance with the criteria summarised below and any fund manager with a discretionary mandate in respect of USS investments must also

have regard to those same criteria when exercising that fund manager's delegated investment powers from USS.

- 2.4 Pension scheme assets must be invested in the best interests of the members and beneficiaries of the Scheme and in the case of any potential conflict of interest, in the sole interest of those members and beneficiaries. Both *Cowan v Scargill* (1994) and *Bishop of Oxford v the Church Commissioners* (1991) still in my view provide clear authority for the view that the best interests of present and future beneficiaries of a pension scheme is their best financial interests. This is also consistent with the primary purpose of a pensions trust which is to deliver financial benefits for the members and beneficiaries of the Scheme in accordance with their entitlements under the Scheme Rules. The Judge in the *Cowan v Scargill* case puts the position clearly as follows (paragraph 41 of the Judgment):

*"When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests. In the case of a power of investment, as in the present case, the power must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risks of the investments in question and the prospects of the yield of income and capital appreciation; both have to be considered in judging the return from the investment".*

- 2.5 The Trustee Company's powers of investment (including where delegated to external fund managers) must also be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole: Regulation 4 of the OPS (Investment) Regulations 2005. This provides statutory recognition of the acceptance by the Courts (including in *Nestle v National Westminster Bank plc*) of the application of modern investment portfolio theory to the exercise of Trustee investment powers emphasising the tolerance of levels of risk across the portfolio as a whole.
- 2.6 The assets of the scheme must also be properly diversified so as to avoid excessive reliance on any particular investment or on any particular investee company or group of investee companies and so as to avoid accumulations of risk in the portfolio as a whole. Investments in securities issued by the same issuer or by issuers in the same group must also not expose the pension fund to excessive risk concentration: Regulation 4(7) of the OPS (Investment) Regulations 2005.

- 2.7 When exercising its investment powers, the Trustee Company has a duty to take all relevant and material considerations into account. The Trustee Company owes a duty to exercise care, skill and diligence on a prudent person standard and must apply the special knowledge and experience which the Trustee Company possesses (both on the investment committee and through LIO). To a greater extent therefore than perhaps in 1999 when I advised, the Trustee Company will have a duty to assess ESG issues as they relate both to asset allocation and to stock selection.
- 2.8 The investments of the pension scheme must also be invested in a manner appropriate to the duration and nature of the expected future retirement benefits payable under the Scheme (Regulation 4(4)) of the above Regulations. This emphasises the obligation to have regard to the long term investment implications of the Fund's investment policy.

**3. Relevance of the above principles to the role of ethical, social and environmental considerations in investment policy**

- 3.1 It is plain that ethical, environmental and social considerations can have a significant financial impact on both the return from and the underlying capital value of particular investments of the pension scheme. A number of studies of the impact of ESG considerations on financial performance and on the assessment of risks associated with particular investments are referred to on page 95 of the UEP FI Report of October 2005 referred to above. Indeed, it is clear that these matters are increasingly taken into account in mainstream investment management.
- 3.2 I confirm my previous advice to the effect that where any ethical, social, environmental, corporate governance issue can be regarded as having a current or potential impact on an actual or contemplated investment, whether from the point of view of the return to be expected of that investment, its liquidity and/or its underlying capital value, it is in my view wholly consistent with the duties of the Trustee Company referred to above to take those considerations into account. If the likely impact as assessed by the Trustee Company (or its investment managers) is sufficiently serious, this may mean a decision by the Trustee Company (a) not to invest in that particular investment or (b) to divest.
- 3.3 As regards a policy of investment exclusion, I see no difficulty from a legal point of view in (a) the selection of investments with a particular ESG profile as part of building a balanced and

properly diversified portfolio (b) "screening in" investments that are expected to yield an attractive return by virtue of their ESG credentials particularly if they are seen as having long term sustainability potential (c) screening out investments that are expected to yield a poor return by virtue of their ESG credentials.

It is important to draw a distinction between (a) an assessment of the likely financial impact of the failure to meet particular ESG standards will have on the return or value of an actual or contemplated investment and (b) the ethical or moral aspects of that failure in the absence of any such financial impact. The Courts in both *Cowan v Scargill* and in *Bishop of Oxford v the Church Commissioners*, go out of their way to stress that it is not the role of the Trustees of a pension scheme or other trust whose objects are to produce financial benefits for the beneficiaries to seek to exclude the making of investments on moral or other non investment grounds. Both cases concede that in the case of certain charitable trusts with very specific charitable objects, it is possible to conclude that particular investment decisions may be repugnant to what may be considered to be the views of the generality of those who benefit from the trust. Examples are given of the Trustees of a cancer charity deciding that its investments should not include tobacco companies and the trustees of a temperance charity deciding that its investments should not include companies which manufacture alcohol. In *Cowan v Scargill*, the Judge added the following (paragraph 48 of the Judgment):

*"But I would emphasise that such cases are likely to be very rare, and in any case I think that under a trust for the provision of financial benefits, the burden would rest, and rest heavy, on him who asserts that it is for the benefit of the beneficiaries as a whole to receive less by reason of the exclusion of some of the possibly more profitable forms of investment..... Under a trust for the provision of financial benefits, the paramount duty of the Trustees is to provide the greatest financial benefits for the present and future beneficiaries."*

- 3.4 Whatever views may be held by sections of the USS membership with regard to those criteria which should be applied on ESG matters in connection with the investment of the assets of USS, I do not see that the recognition by the Courts that in the case of certain charitable trusts, a consensus or majority view on the part of the beneficiaries that certain categories of investment ought to be avoided, provides any authority for the proposal that such a principle might be applied

in the context of USS. The right approach in law for the Trustee Company is only to pay regard to ESG considerations to the extent that they are relevant to the statutory or trust law investment criteria and principles which I have summarised above. This may enable (or indeed in certain cases require) certain investment or disinvestment decisions to be taken. However, where that is the case, the investment decision will have been driven by the relevant financially driven investment criteria, not by the influence of any extraneous moral consideration.

#### 4. Conclusions

In response to the questions raised by PGGM in their note to you of 1 August, I would respond briefly as follows as regards the absence in USS investment policy of criteria for investment exclusion.

- 4.1 This is based on the need for the Trustee Company to comply with its duties both under trust law and under Section 36 of the Pensions Act 1995 when read with the Occupational Pension Schemes (Investment) Regulations 2005.
- 4.2 Specific investment or sector exclusions are permitted only insofar as they are consistent with the above duties of the Trustee Company and with the purpose for which the investment powers must be exercised.
- 4.3 Based on the advice that I gave in 1998, as far as I can see, the original decision of the Trustee Company not to have exclusions was based partly on my advice but also on the impracticality of operating a policy of exclusion given the size of the fund and the preference for a policy of constructive engagement as better suited to the circumstances of the Fund and the need to ensure both diversification and investment suitability.
- 4.4 As regards Freshfields commentary, I do not share many of the criticisms which Freshfields make of the reliability of *Cowan v Scargill* as legal authority. Indeed, the key principles which it records are in my view consistent both with trust law and with those more specific requirements which are now set out under the amended Section 36 of the Pensions Act 1995.
- 4.5 The Court recognises in both *Cowan v Scargill* and in *Bishop of Oxford v the Church Commissioners* that in the case of a large pension fund, the emphasis on a need for diversification of investments is heightened. This also finds its reflection in

Regulation 4(7) when read with Regulation 4(4) of the OPS (Investment) Regulations 2005. These say that the investments of the Scheme must be properly diversified in terms of risk spreading but also to ensure that the assets of the Scheme are invested in a manner appropriate to the nature and duration of the expected future retirement benefits payable under the pension scheme. This in turn emphasises the long term view which the Trustee Company is empowered and indeed obliged to take when investing pension fund assets to which ethical, environmental and investee company governance considerations are plainly of the first relevance.

- 4.6 Freshfields contend that *Cowan v Scargill* (1984) has been generally misunderstood to support the proposition that pension scheme trustees have an obligation to maximise financial return to the exclusion of all other considerations in relation to each and every investment. I personally did not read the case in that way and my 1998/99 advice emphasised the importance of the portfolio approach. Since 30 December 2005, pension scheme trustees are expressly required to exercise their investment powers in a manner calculated to ensure that the security, quality, liquidity and profitability of the portfolio as a whole. One can see that ESG considerations can be relevant here both as regards asset allocation, the choice of particular categories or sectors of investment (e.g. investment in renewable energy) and for the portfolio as a whole.
- 4.7 In my view, USS policy of constructive engagement which it adopts itself (through LIO) and requires to be adopted in the exercise of delegated powers on the part of its external fund managers, is consistent with the trust law and Pensions Act duties of the Trustee Company, without any legal obligation being imposed on the Trustee Company to operate a policy of exclusion by reference to pre-set criteria. It seems to me that the difficulties of operating such a policy (as set out at section 6 of the Chairman's letter of 16 January 1998) are every bit as relevant now as they were then, quite apart from the legal difficulty of reconciling such exclusions with the principles which I have described above. There is judicial comment both in the *Cowan v Scargill* and in the Bishop of Oxford case to the effect that it is not the role of Trustees to attempt to reconcile conflicting moral positions as regards investment of funds under their stewardship in trusts for the provision of financial benefits.
- 4.8 This advice applies naturally to English law. Given that the duties of pension fund trustees will be governed on an EU wide

basis by the EU Pension Funds Directive, there will of course be a considerable amount of common ground with other EU jurisdictions including Holland. I naturally offer no opinion on this matter to PGGM though I have no objection at all to copying this letter to them if you consider that appropriate. The letter from the Chairman which is attached of 16 January 1998 was widely circulated (at least to USS institutions) so I see no real difficulty with a copy of that original letter also being made to PGGM on the same basis in the spirit of cooperation between large institutional investors.

I trust that this advice will be of assistance to you both in responding to PGGM and more generally.

With kind regards

Yours sincerely

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