UNIVERSITIES SUPERANNUATION SCHEME

RESPONSIBLE INVESTMENT - LEGAL CONSIDERATIONS

1. SUMMARY

1.1 The purpose of this paper is to set out our advice to the Trustee Company[1] with regard to the legal considerations to be taken into account when exercising its investment duties. In particular, we are asked to update our previous advice[2] in relation to the extent to which ethical, environmental, social and governance grounds can be taken into account when considering the exercise of the Trustee Company's investment duties.

1.2 It remains our advice that that the Trustee Company's primary duty is to invest Scheme assets in the best financial interests of members and beneficiaries. It is consistent with that duty to take into account ethical, environmental, social and governance issues where these are relevant financial factors.

1.3 However, it would be incompatible with the investment duties of the Trustee Company to operate a policy of investment exclusion on the grounds of non-financial considerations alone. To do so would be to fetter the exercise of the Trustee Company's discretion.

1.4 The Trustee Company must observe certain procedural duties when making investment decisions. It must take into account relevant considerations, it must not fetter its discretion, it must have the correct decision-making process (including consultation with the Scheme's participating employers) and it must take advice.

1.5 The Trustee Company must have regard to financial factors when considering how best to exercise its powers and duty to invest (including to retain or to disinvest) Scheme assets. Only once that has happened could the Trustee Company give consideration to any non-financial factors.

1.6 Non-financial factors should only be taken into account in limited circumstances, namely where the Trustee Company has good reason to believe that members would share its views and that there is no risk of significant financial detriment to the Scheme.

1.7 Consequently, where ESG or ethical considerations are non-financial factors (i.e. they do not pose a risk to the prospect of the financial success of the investment) these should not drive investment decisions. They are to be considered only once financial factors have been taken into account, and then only in the limited circumstances outlined above.

1.8 The Law Commission's report, and the consequent Government consultation, have not resulted in any change to the law. However, the report is helpful in clarifying the scope of trustees' fiduciary duties.

Our advice relates to the investment duties of trustees of a defined benefit pension scheme. Different considerations apply in defined contribution schemes where members have a choice in where their funds are invested, albeit from a range of investments selected by the Trustee Company.

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[1] USS Limited as sole corporate trustee of the Universities Superannuation Scheme

[2] Letter from DLA Piper to David Russell, 8 September 2006

2. THE LAW COMMISSION REPORT

2.1 There have been a number of developments in relation to responsible investment since we last advised on this issue in 2006. In particular, the Law Commission was tasked by the Department of Business, Innovation and Skills, and by the Department for Work and Pensions ('DWP'), to investigate how the law of fiduciary duties applies to investment intermediaries and to evaluate whether the law works in the interests of the ultimate beneficiaries.

2.2 It is worth noting briefly the status of the Law Commission. The Law Commission is a statutory independent body created to keep the law under review and to recommend reform where it is needed. It has no power to make or change the law, only to recommend that the Government does so.

2.3 The Law Commission issued a consultation in October 2013 and published its final report on 30 June 2014.[3] In summary, and so far as relevant to this advice, the Law Commission concluded that it did not advocate legislation to codify the law, noting that fiduciary duties are difficult to define and inherently flexible.[4] It did, however, suggest that more guidance is needed[5] and that this should be provided primarily by the Pensions Regulator in a new Code of Practice.

2.4 The Law Commission also considered potential changes to the Investment Regulations[6], recommending that the Government review two particular aspects: the reference to "social, environmental or ethical considerations" as one of the matters to be included in the Statement of Investment Principles, and whether trustees should be required to state their policy (if any) on stewardship.

2.5 In response to the Law Commission's report, the DWP issued a consultation[7] on changes to the Investment Regulations, and in November 2015 they published the response to that consultation.[8] In summary, the Government does not propose any changes to the law at this stage. The proposals set out in those consultations and the response are covered in more detail in section 6 below.

3. CURRENT LAW

The law, which has remained substantially unchanged in the area of investment duties since our 2006 advice was given, may be summarised as follows.

3.1 Where is the law?

As noted by the Law Commission,[9] the law comes from several sources including the scheme rules, legislation, duties which attach to a power and duties of care.

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[3] Law Commission Report

[4] At paragraphs 7.36 to 7.37

[5] At paragraphs 7.43 and 7.51 to 7.57

[6] Occupational Pension Schemes (Investment) Regulations 2005 SI 2005/3378

[7] Consultation on changes to the Investment Regulations following the Law Commission's report "Fiduciary Duties of Investment Intermediaries" 26 February 2015

[8] The consultation and the response can be viewed here

[9] At paragraph 7.35

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 it 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 is a trust established for the provision of pensions and related benefits. 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 benefits to be provided.

3.2 The statutory duty

Under Section 36(1A) Pensions Act 1995 when read with regulation 4 of the Investment Regulations, the Trustee Company must exercise its investment powers in the best interests of members and beneficiaries, and in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole. The Regulations go on to specify further requirements in relation to the exercise of investment powers, including that the assets must be invested in a manner appropriate to the nature and duration of the scheme's liabilities. This emphasises the long term nature of the Trustee Company's investment policy. Assets must also be properly diversified so as to avoid excessive reliance on any particular investment or accumulations of risk in the portfolio as a whole.

Any fund manager with a discretionary mandate in respect of USS investments must have regard to the same criteria when exercising its delegated investment powers.

3.3 Case law: best interests of members and beneficiaries

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* (1984) and *Bishop of Oxford v the Church Commissioners* (1991)[10] are clear authority for the view that the best interests of beneficiaries of a pension scheme is their best financial interests. This is also consistent with the primary purpose of a pension trust which is to deliver financial benefits for the members and beneficiaries of the Scheme. The Judge in the *Cowan v Scargill* case puts the position clearly as follows:[11]

"*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*".

3.4 Case law: risk across the portfolio as a whole

The Trustee Company's powers of investment must also be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole. The courts have recognised that the concept of risk must adapt to current economic conditions and contemporary understanding of the markets[12]. Accordingly, trustees are "*entitled to be judged*

[10] [1991] PLR 185

[11] [1984] 2 All ER 750 at paragraph 41

[12] See Nestle v National Westminster Bank plc [1993] 1 WLR 1260

by the standards of current portfolio theory, which emphasises the risk level of the entire portfolio rather than the risk attaching to each investment in isolation".[13]

3.5 Trustee duties

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 USS Investment Management Ltd).

3.6 Challenging trustee decisions

As a general principle, the courts will not interfere in a trustee decision properly made. This is equally true of investment decisions where the court will not be concerned with the outcome of the investment, but rather that the trustees made the decision in the right way and took into account the right considerations.

4. APPLICATION OF THE ABOVE PRINCIPLES TO "RESPONSIBLE INVESTMENT"

4.1 Terminology: financial and non-financial factors

It is apparent from the Law Commission's report that clarity is needed around terminology, with references to "ESG"[14] or "ethical" being potentially misleading. Instead the Law Commission refers to "financial factors" and "non-financial factors".[15]

Financial factors are those which are relevant to increasing returns or reducing risks. Non-financial factors are motivated by broader concerns such as improving members' quality of life or showing disapproval of certain industries.

4.2 Extent to which ethical and ESG factors can be taken into account

It is clear that trustees *may* take ethical, environmental, social and governance factors into account. Where ethical, environmental, social or governance issues can be regarded as having a current or potential financial impact on an investment, whether from the point of view of expected return, liquidity or underlying capital value it is in our view entirely consistent with the Trustee Company's duties referred to above to take those considerations into account.

This is the case both for investment, and disinvestment. A decision to retain an investment, or to disinvest, is subject to the same legal considerations, including as to ethical and ESG factors, as a decision to make the investment. Where the impact of those factors is assessed by the Trustee Company to be sufficiently serious, it may lead to a decision not to make an investment or to disinvest from it.

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[13] Nestle v National Westminster Bank plc (1996) 10(4) Trust Law International 112 at 115

[14] Environmental, social and governance

[15] See paragraphs 5.61 and 5.62, and Chapter 6

4.3 Non-financial factors

It is clear that the law is sufficiently flexible to allow non-financial considerations to be taken into account but these should not inhibit the proper exercise of the Trustee Company's powers. Non-financial factors should be second order, i.e. only taken into account once the financial factors have been considered. We consider this further in paragraph 4.4 below.

We would also note the Law Commission's conclusion that non-financial factors should be taken into account only in limited circumstances, namely where the Trustee Company has good reason to think that members would share their view, and there is no risk of significant financial detriment to the Scheme. We agree with this conclusion.

As noted above non-financial factors only fall to be considered after financial factors have been taken into account. If decisions are then made taking non-financial factors into account which could have a significant detrimental financial impact on the Scheme, this could prejudice the proper fulfilment of the duty to act in members' best financial interests. The Law Commission also notes in this context that trustees of defined benefit schemes have to weigh their duties to members against any possible threat to the employer's ability to make contributions and not impose burdens which "*imperil the continuity and proper development of the employers' business*". It notes that trustees should not become distracted from these core tasks by the consideration of non-financial factors.[16]

We would make three further observations, all on the subject of members' views. The first is that the Trustee Company would need to have good reason to think that members shared its view, which means that the Trustee Company must first have formed its own view. Ultimately investment is a trustee decision.

Second, whilst the Trustee Company may take members' views into account, it is not under any obligation to do so.[17] The Trustee Company must make the ultimate decision and it should not fetter that decision by ruling out particular investments or classes of investment on non-financial grounds, whether on account of their own views or the views of members.

The final observation that we would make, and which is also made in the Law Commission's report,[18] is that the views of a member or group of members may not be shared by other members. The Trustee Company has a duty to the membership as a whole and it would not be appropriate potentially to prejudice the position of one group of members by selecting (or excluding) investments on non-financial grounds supported by another group of members. That does not necessarily mean that there has to be unanimity amongst members, but it does mean that the Trustee Company should not act in accordance with some members' views without more evidence of the views of the wider membership.

4.4 Policy of investment exclusion

We were specifically asked in 2006 to advise in relation to whether it is appropriate for the Trustee Company to operate a policy of investment exclusion. We can see no difficulty from a legal point of view in selecting investments with a particular ethical, environmental, social or governance profile as part of building a balanced and properly diversified portfolio, including "screening in" investments that are expected to yield an attractive return because of

[16] At paragraph 6.82

[17] A conclusion shared by the Law Commission, see paragraph 6.82

[18] At paragraphs 6.57 to 6.67

those factors. Similarly it is right to exclude investments where there are concerns that ethical, environmental, social and/or governance factors could pose a risk to the financial success of the investment.

It is important to draw a distinction between (a) an assessment of the likely financial impact that 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, or as the Law Commission puts it, between financial and non-financial factors.

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 exclude certain investments solely on moral or other non-investment grounds. It is not for the trustees to impose their own moral, ethical or political views on members; instead they must do their "*best to exercise fair and impartial judgment*" in the interests of their beneficiaries.[19] Both cases concede that for 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:[20]

"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."

The courts have recognised that a consensus or majority view from beneficiaries may affect the investment decisions made in certain charitable trusts. However, we do not see that this provides any authority for the proposal that such a principle might be applied in the differing context of USS, which is not a charity and does not have charitable objects.

The Law Commission is undertaking a separate review on investment by charitable trusts, but it notes in this report that a charity can invest having regard both to financial return and the investments which best further the objects of the charity.[21] It also notes that particular regard may be had to members' views where a pension scheme is established by an "affinity group"[22] which shares a particular moral or political viewpoint.

As noted above, USS is not a charity and does not have charitable objects; its function is solely to provide pensions and related benefits to its beneficiaries. Neither it is established by an affinity group, but instead has a significant number of sponsoring employers, and a large and diverse membership. As noted at paragraph 4.3 above, it would not be appropriate for

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[19] Martin v City of Edinburgh District Council [1989] Pens LR 9

[20] Paragraph 48

[21] Paragraphs 1.28 and 1.31

[22] Paragraph 6.93

the Trustee Company to act on the views of one group of members without more evidence of the views of the wider membership. Similarly, the Trustee Company is required by statute to consult with the employers in relation to its investment strategy. In doing so it must consider the views of the employers generally having regard to the overall financial health of the Scheme, and therefore the impact on all employers under the cost sharing arrangements.

We should also take this opportunity to note that although some participating employers in USS have charitable status, USS itself is not a charitable trust. Once contributions have been paid into the Scheme they become Scheme assets and the Trustee Company is bound to invest those assets in a manner consistent with the legal obligations set out in this paper.

The right approach in law for the Trustee Company is therefore to pay regard only to financial factors, and not so some extraneous moral factor, when considering how best to exercise their investment powers. Only once that process has been undertaken, and in the limited circumstances outlined above, should consideration be given to non-financial factors. Those non-financial factors should not drive the investment decision.

4.5 A further note about charitable trusts - Opinion of Mr McCall QC

We have been made aware of an Opinion from Leading Counsel on the subject of "*The powers and duties of charity trustees as to ethically questionable investments with specific reference to carbon intensive assets*".[23] Counsel was instructed by a firm of solicitors acting on its own account but Counsel has agreed to the publication of the Opinion for general consumption.

The Opinion is specific to charitable trusts and is therefore of limited application to a multi-employer pension trusts such as USS. However, it does touch on the duties of other fiduciaries and we summarise below some of the relevant conclusions from the Opinion.

4.5.1 Counsel concludes that "*investment is a word which denotes the intent to secure a financial return for the beneficiaries and so the starting point when investing is to seek to find the best financial returns in the market, whilst having regard to the need to manage risk.*"[24]

4.5.2 Counsel notes[25] that the risk of paying too much for an investment because its price does not properly reflect the cost to the investee business of taxes, duties or other regulation designed to offset a social cost is a consideration that must properly be taken into account by any fiduciary, including pension fund trustees. He goes on to note that it will be hard for charity trustees to justify the exclusion of certain assets from the range of assets open to them unless it is possible to combine financial doubts with what those trustees consider to be relevant social or environmental doubts as well. This is consistent with our conclusions at paragraphs 4.2 and 4.4 above.

4.5.3 He also notes[26] that where the financial considerations applicable to two alternative investment strategies are such that either could be justified, then trustees have discretion to make their choice on ethical grounds. This is

[23] Opinion of Mr Christopher McCall QC, November 2015 available here

[24] Paragraph 35 of the Opinion

[25] Paragraph 4 of the Opinion

[26] Paragraph 14 of the Opinion

consistent with our conclusion that non-financial grounds are only to be taken into account once financial factors have been considered (see paragraph 4.3 above).

4.5.4 Even in the case of charity trustees, Counsel urges caution before using charitable trust assets to make moral or ethical statements unless it is necessary or permissible to do so to achieve the purposes of the charity.[27]

5. APPLICATION OF THE ABOVE PRINCIPLES TO DEFINED CONTRIBUTION INVESTMENTS

The focus of this paper is on the Trustee Company's duties to invest the assets of the defined benefit section of the Scheme. However, as USS moves towards a hybrid model it is worth noting the application of the investment obligations to the selection and monitoring of defined contribution (DC) investment options.

The statutory framework that applies to defined benefit schemes applies in substantially the same terms to defined contribution schemes. There is also additional legislation and supporting guidance from the Pensions Regulator for DC schemes, covering such matters as fees, value for money and governance. Evidence suggests that a considerable proportion of DC scheme members are not engaged with pensions and do not make active investment choices. Much of the legislation and regulation is therefore focused on trustees providing and monitoring a suitable default fund, and this is also the primary focus of the sections of the Law Commission's report dealing with DC arrangements.[28]

However, the Report does note that trust law must be interpreted flexibly in order to fit the fundamentally different risk model of DC. In a DC scheme, members bear both the benefits and the risk of the investment decision. Members should therefore be able to make informed ethical choices. The Law Commission notes that where trustees are faced with members' clearly articulated views, they should attempt to provide a suitable choice of funds.[29]

6. PROPOSAL FOR CHANGE TO THE INVESTMENT REGULATIONS

Whilst the Law Commission concluded that no codification of the law on fiduciary duties was required, it did conclude that the Government should consider two changes[30] to the Investment Regulations.

6.1 Statement of Investment Principles (SIP): statement on ESG

The Investment Regulations provide that the SIP has to contain a statement 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".[31]

The Law Commission concluded that this does not help trustees to understand what factors they should take into account in their investment decisions. The Government responded with

[27] Paragraph 20 of the Opinion

[28] Chapters 8 & 9

[29] At paragraph 6.83

[30] Three areas were put forward, but only two are relevant here. The third relates to the application of the Investment Regulations to small schemes of fewer than 100 members

[31] Regulation 2(3)(vi)

a consultation about potential changes to the Investment Regulations but concluded in its November response to that consultation that changing the Regulations would not necessarily lead to greater clarity for trustees and that guidance would be more effective in this area than regulatory change.[32] The Government also noted that there is evidence that trustees already have a good awareness of their duty to consider factors, including ESG factors, which could be material to financial performance of investments over the long term.

The requirement to provide the statement on ESG considerations in the SIP will therefore remain unchanged, and we can expect to see additional guidance for trustees from the Pensions Regulator in due course.

6.2 Compliance with the UK Stewardship Code

The Law Commission also concluded that it is in the interests of pension funds to engage with the companies in which they invest, whilst noting that there is no legal obligation to comply with the Code. Again, the Government consulted on changing the Investment Regulations explicitly to require trustees to state that they comply with Code, or to explain why they have not done so. Responses to the consultation were mixed and the Government has decided not to legislate in this regard.

In common with many UK pension funds, USS does comply with the Stewardship Code; indeed it was one of the founder signatories in 2010. It is also a signatory to the Principles for Responsible Investment and publishes a considerable amount of information on its website about its approach to responsible investment. It has also set out its approach to investment in particular asset classes in its PRI USS RI Transparency Report.[33] USS therefore goes beyond its legal duties in terms of its approach to stewardship, and also to communicating its approach to responsible investment, including ESG factors and stewardship, with members and beneficiaries.

7. CONCLUSIONS

7.1 The Trustee Company must comply with its duties both under trust law and legislation.

7.2 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.

7.3 The courts have recognised that pension fund trustees need to ensure proper diversification of their assets in order to ensure that the risks are properly spread and to ensure that the assets are invested in a manner appropriate to the nature and duration of the scheme's liabilities. This in turn means that a long-term view has to be taken, and that in turn must properly involve the consideration of financial factors, including ethical, environmental, social and governance factors which could have an impact on the success of that investment.

7.4 Pension scheme trustees are expressly required to exercise their investment powers in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole. It is clear that ethical, environmental, social and governance factors can be relevant here as regards asset allocation, the choice of particular categories or sectors of investment

[32] See paragraph 23 of the Response to Consultation

[33] PRI Transparency Report

and for the portfolio as a whole. However, this is only where those factors could have a financial impact on those investments.

7.5 The right approach in law for the Trustee Company is to pay regard to financial factors, and not to some extraneous moral factor, when considering how best to exercise their investment powers. Only once that decision is made can they consider non-financial factors (noting that they need not do so). Non-financial factors may, however, only be taken into account in limited circumstances, namely where the Trustee Company has reason to believe that the membership shares its view and there is no risk of significant financial detriment to the Scheme. It is clear that non-financial factors should not drive the investment decision.

7.6 USS has a policy of constructive engagement which 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. There is judicial comment, referred to above, 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.

DLA Piper UK LLP
8 March 2016