Financial institutions
Energy
Infrastructure, mining and commodities
Transport
Technology and innovation
Life sciences and healthcare

NORTON ROSE FULBRIGHT

Trustees' investment duties and ESG factors

Briefing

February 2019

Summary

New regulations which come into force in October 2019 will change the way in which trustees must document in their statements of investment principles (SIPs) (i) how they have considered "environmental, social and governance" (ESG) factors in making investment decisions and (ii) their policy towards "stewardship".

From October 1, 2020, trustees of certain schemes must include an implementation statement in the annual report setting out to what extent the SIP has been followed during the scheme year. There are also new requirements in relation to certain schemes making available their SIPs and implementation statements.

As a next step, trustees should consider how they need to update their SIPs in relation to the consideration of ESG factors and their policy on stewardship.

Background

In June 2017, following a call for evidence in November 2016, the Law Commission published a report on "Pension Funds and Social Investment". The report considered whether there were legal or regulatory barriers to using pension funds for social impact, including investment in social enterprises.

The Law Commission's report suggested a number of legislative changes and "options for reform". In response to the Law Commission's report, the Department for Work and Pensions (DWP) published its final response in June 2018, alongside a consultation in relation to new draft regulations. The DWP published its consultation response in September 2018, on the same date on which the new regulations, the Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018 (the Amending Regulations), were laid before Parliament.

Changes introduced by the Amending Regulations

The following changes will take effect from October 1, 2019

Inclusion of policy in relation to "financially material considerations"
This change applies to all schemes which are required to prepare a SIP.

Regulation 2(3)(b)(vi) of the Occupational Pension Schemes (Investment) Regulations 2005 (the Investment Regulations) currently requires trustees to include in their SIP their policy in relation to "the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments".

Under the Amending Regulations, this requirement will be replaced by a wider reference to "financially material considerations over the appropriate time horizon of the investments, including how those considerations are taken into account in the selection, retention and realisation of investments".

"Financially material considerations" are defined as including (but not limited to) "environmental, social and governance considerations (including but not limited to climate change), which the trustees of the trust scheme consider financially material".

The "appropriate time horizon" is defined as "the length of time that the trustees of a trust scheme consider is needed for the funding of future benefits by the investments of the scheme."

The reference to the "appropriate time horizon" will allow trustees of schemes which, for example, are looking to buy-out benefits and wind-up in the foreseeable future, to take the relevant timings into account when setting out their policy on ESG considerations.

Inclusion of policy in relation to "non-financial matters"
This change applies to all schemes which are required to prepare a SIP.

Under the Amending Regulations, a new Regulation will be included in the Investment Regulations which provides trustees with the option to include in the SIP their policies in relation to "the extent (if at all) to which non-financial matters are taken into account in the selection, retention and realisation of investments".

"Non-financial matters" are defined as "the views of the members and beneficiaries including (but not limited to) their ethical views and their views in relation to social and environmental impact and present and future quality of life of the members and beneficiaries of the trust scheme".

The Law Commission's report included an "option for reform" that the Government should consider "whether pension schemes should be required to ask their members periodically for their views on social investment and non-financial factors." The changes to the Investment Regulations under the Amending Regulations do not make this a requirement, but allow trustees the option to include in the SIP details of any such policy they have in place. However, given that this proposal was not popular among schemes and will not be easy to implement, it is unlikely that many schemes will opt to do this.

Inclusion of policy in relation to stewardship

This change applies to

- All schemes which are required to prepare a SIP.
- "Relevant schemes" with more than 100 members in relation to the default investment strategy.

Regulation 2(3)(c) of the Investment Regulations will be amended to require trustees to include in the SIP their policy in relation to "stewardship".

For the purposes of the Law Commission's report, "stewardship" was considered to be "the activity of investors engaging with the underlying investment in order to promote its long-term success, through monitoring, engagement or voting, either directly or through their investment managers. In this context, an investment could be equities (shares in a company), but it could also be investment in an alternative asset class, for example in relation to an infrastructure project."[1]

The Investment Regulations, as amended, will specifically require trustees to disclose in the SIP their policy in relation to

- The exercise of the rights (including voting rights) attaching to the investments.
- Undertaking engagement activities in respect of the investments, including the methods by which trustees monitor and engage with others about relevant matters.

For these purposes, "relevant matters" include (but are not limited to) "matters concerning an issuer of debt or equity, including their performance, strategy, risks, social and environmental impact and corporate governance."

This requirement will also apply to "relevant schemes" (broadly schemes providing money purchase benefits) with 100 or more members, which must disclose in the default investment strategy their policy in relation to the stewardship.

Publishing the SIP

This change applies to "relevant schemes" which are required to prepare a SIP.

Trustees of "relevant schemes" (broadly, schemes providing money purchase benefits) which must prepare a SIP will be required to make publicly available free of charge the SIP on a website or, where appropriate, in hard copy form.

Trustees must also include details about the availability of the SIP in the annual benefit statements issued to members with money purchase benefits.

1 Paragraph 2.24 of the Law Commission's report on "Pension funds and social investment".

The following new requirements will take effect from October 1, 2020

Inclusion of an implementation statement in annual report
This change applies to "relevant schemes" which are required to prepare a SIP.

Trustees of "relevant schemes" (broadly, schemes providing money purchase benefits) which must prepare a SIP will be required to include an "implementation statement" in the annual report. The implementation statement must

- Describe the extent to which the SIP has been followed during the scheme year.
- Describe any review of the SIP during the scheme year.
- Explain any changes made to the SIP during that year and the reasons for the change.
- Where no review has been carried out, set out the date of the last review.

Provision of the implementation statement to members
This change applies to "relevant schemes" which are required to prepare a SIP.

Trustees of "relevant schemes" (broadly, schemes providing money purchase benefits) which are required to prepare a SIP will be required to make publicly available free of charge the implementation statement on a website or, where appropriate, in hard copy form.

Trustees must also include details about the availability of the implementation statement in the annual benefit statements issued to members with money purchase benefits.

FCA's response to the Law Commission's report

The FCA's response to the Law Commission's report was included as part of DWP's response in June 2018, in which the FCA confirmed that it broadly supported parallel changes to the COBS rules (the rules of the FCA for regulating the conduct of the business of authorised persons) and related guidance in relation to contract-based schemes. The FCA confirmed that it would consult on a single package of changes in relation to contract-based schemes in the first quarter of 2019.

FRC's consultation on proposed changes to UK Stewardship Code

On January 30, 2019, the Financial Reporting Council (FRC) published a consultation on its proposed amendments to the Stewardship Code. The main proposed changes are

- Broadening the scope of the Code to include investment decision-making and investment in assets other than listed equities.
- Asking signatories to establish an organisational purpose, strategy, values and culture that enable them to fulfil their stewardship objectives.
- Recognising the importance of ESG factors.
- Requiring signatories to make public disclosures about their stewardship activities and their assessment of how effectively they have achieved their stated objectives.

The revised Code would consist of ten principles, which must be followed on an "apply and explain" basis, and 27 provisions, which must be followed on a "comply or explain" basis.

The consultation closes on March 29, 2019.

Next steps

Schemes should consider which of the new requirements will apply to them and how to implement these changes. In summary, by October 1, 2019, certain schemes will be required to do some or all of the following

- Update their SIP
- Update the SIP in respect of their default arrangement
- Publish their SIP

From October 1, 2020, certain schemes will also be required to produce and publish their implementation statement.

Global resources

Norton Rose Fulbright is a global law firm. We provide the world's preeminent corporations and financial institutions with a full business law service. We employ 4000 lawyers and other legal staff based in more than 50 cities across Europe, the United States, Canada, Latin America, Asia, Australia, the Middle East and Africa.

People worldwide

>7000

Legal staff worldwide

>4000

Offices

56

Key industry strengths

- Financial institutions
- Energy
- Infrastructure, mining and commodities
- Transport
- Technology and innovation
- Life sciences and healthcare

Our office locations

Europe

- Amsterdam
- Athens
- Brussels
- Frankfurt
- Hamburg
- Istanbul
- London
- Luxembourg
- Milan
- Monaco
- Moscow
- Munich
- Paris
- Piraeus
- Warsaw

United States

- Austin
- Dallas
- Denver
- Houston
- Los Angeles
- Minneapolis
- New York
- St Louis
- San Antonio
- San Francisco
- Washington DC

Canada

- Calgary
- Montréal
- Ottawa
- Québec
- Toronto
- Vancouver

Latin America

- Mexico City
- Rio de Janeiro
- São Paulo

Asia Pacific

- Bangkok
- Beijing
- Brisbane
- Canberra
- Hong Kong
- Jakarta[1]
- Melbourne
- Port Moresby (Papua New Guinea)
- Perth
- Shanghai
- Singapore
- Sydney
- Tokyo

Africa

- Bujumbura[3]
- Cape Town
- Casablanca
- Dar es Salaam
- Durban
- Harare[3]
- Johannesburg
- Kampala[3]
- Nairobi[3]

Middle East

- Bahrain
- Dubai
- Riyadh[2]

1 TNB & Partners in association with Norton Rose Fulbright Australia
2 Mohammed Al-Ghamdi Law Firm in association with Norton Rose Fulbright US LLP
3 Alliances

nortonrosefulbright.com

NORTON ROSE FULBRIGHT

Contacts

If you would like further information please contact:

London

Lesley Browning
Partner
Tel +44 20 7444 2448
lesley.browning@nortonrosefulbright.com

Peter Ford
Partner
Tel +44 20 7444 2711
peter.ford@nortonrosefulbright.com

Norton Rose Fulbright

Norton Rose Fulbright is a global law firm. We provide the world's preeminent corporations and financial institutions with a full business law service. We have more than 4000 lawyers and other legal staff based in more than 50 cities across Europe, the United States, Canada, Latin America, Asia, Australia, the Middle East and Africa.

Recognized for our industry focus, we are strong across all the key industry sectors: financial institutions; energy; infrastructure, mining and commodities; transport; technology and innovation; and life sciences and healthcare. Through our global risk advisory group, we leverage our industry experience with our knowledge of legal, regulatory, compliance and governance issues to provide our clients with practical solutions to the legal and regulatory risks facing their businesses.

Wherever we are, we operate in accordance with our global business principles of quality, unity and integrity. We aim to provide the highest possible standard of legal service in each of our offices and to maintain that level of quality at every point of contact.