

### **Excerpt from Local Government Pension Scheme: Guidance on Preparing and Maintaining an Investment Strategy Statement (DCLG September 2016)**

Regulation 7(2)(e) - How social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments

When making investment decisions, administering authorities must take proper advice and act prudently. In the context of the local government pension scheme, a prudent approach to investment can be described as a duty to discharge statutory responsibilities with care, skill, prudence and diligence. This approach is the standard that those responsible for making investment decisions must operate.

Although administering authorities are not subject to trust law, those responsible for making investment decisions must comply with general legal principles governing the administration of scheme investments. They must also act in accordance with ordinary public law principles, in particular, the ordinary public law of reasonableness. They risk challenge if a decision they make is so unreasonable that no person acting reasonably could have made it. The law is generally clear that schemes should consider any factors that are financially material to the performance of their investments, including social, environmental and corporate governance factors, and over the long term, dependent on the time horizon over which their liabilities arise.

However, the Government has made clear that using pension policies to pursue boycotts, divestment and sanctions against foreign nations and UK defence industries are inappropriate, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government.

Although schemes should make the pursuit of a financial return their predominant concern, they may also take purely non-financial considerations into account provided that doing so would not involve significant risk of financial detriment to the scheme and where they have good reason to think that scheme members would support their decision.

Investments that deliver social impact as well as a financial return are often described as “social investments”. In some cases, the social impact is simply in addition to the financial return; for these investments the positive social impact will always be compatible with the prudent approach. In other cases, some part of the financial return may be forgone in order to generate the social impact. These investments will also be compatible with the prudent approach providing administering authorities have good reason to think scheme members share the concern for social impact, and there is no risk of significant financial detriment to the fund.

## **Summary of requirements**

In formulating and maintaining their policy on social, environmental and corporate governance factors, an administering authority:-

- ☐ **Must take proper advice**
- ☐ **Should explain the extent to which the views of their local pension board and other interested parties who they consider may have an interest will be taken into account when making an investment decision based on non-financial factors**
- ☐ **Must explain the extent to which non-financial factors will be taken into account in the selection, retention and realisation of investments**
- ☐ **Should not pursue policies that are contrary to UK foreign policy or UK defence policy**
- ☐ **Should explain their approach to social investments**

### **Regulation 7(2)(f) - The exercise of rights (including voting rights) attaching to investments**

The long-term investment interests of administering authorities are enhanced by the highest standards of corporate governance and corporate responsibility amongst the companies in which they invest. Poor governance can negatively impact shareholder value.

Stewardship aims to promote the long term success of companies in such a way that the ultimate providers of capital also prosper. Stewardship activities include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure and corporate governance, including culture and remuneration. Engagement by administering authorities is purposeful and can identify problems through continuing dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings.

Engagement enables administering authorities as long term shareholders to exert a positive influence on companies to promote strong governance, manage risk, increase accountability and drive improvements in the management of environmental, social and corporate governance issues.

Administering authorities are encouraged to consider the best way to engage with companies to promote their long-term success, either directly, in partnership with other investors or through their investment managers, and explain their policy on stewardship with reference to the Stewardship Code. Administering authorities should become Signatories to the Code and state how they implement the seven principles and guidance of the Code, which apply on a “comply or explain” basis.

Concern has been expressed in the past about the scope of Regulation 12(2)(g) of the 2009 Regulations which, in effect, allowed each administering authority to decide whether or not to adopt a policy on the exercise of the rights attaching to investments, including voting rights. To increase awareness and promote engagement, Regulation 7(2)(f) now requires every administering authority to formulate a policy that reflects their stewardship responsibilities.

### **Summary of requirements**

In formulating their policy on the exercise of rights, administering authorities:-

- ☐ **Must give reasons in their Investment Strategy Statement for not adopting a policy of exercising rights, including voting rights, attaching to investments**
- ☐ **Should, where appropriate, explain their policy on stewardship with reference to the Stewardship Code**
- ☐ **Should strongly encourage their fund managers, if any, to vote their company shares in line with their policy under Regulation 7(2)(f)**
- ☐ **May wish to appoint an independent proxy voting agent to exercise their proxy voting and monitor the voting activity of the managers, if any, and for reports on voting activity to be submitted annually to the administering authority**
- ☐ **Should publish a report of voting activity as part of their pension fund annual report under Regulation 57 of the 2013 Regulations**