Fiduciary duties relating to ethical considerations

Introduction

At the request of the Pension Fund Committee, this report sets out the position regarding the Fund's fiduciary duties with regard to ethical investment considerations.

In particular, Members of the Committee had previously noted that the Australian superannuation fund, First State Super, had announced a decision to divest from tobacco investments. In doing so, Members were reminded of the overriding duty on the Fund to 'maximise returns for its beneficiaries'.

The imminent transfer of public health responsibilities to the County Council from April 2013 has also raised the profile of such investments by the Pension Fund.

What is 'fiduciary duty' in this context?

Fiduciary duties set out the broad parameters within which trustees (and the fund managers and investment consultants whom they have engaged) must exercise the discretionary powers conferred by the terms of the trust. These duties affect the exercising of discretion to make and manage investments, and require trustees and their agents to act prudently and for a proper purpose. In this context the Pension Fund Committee are regarded as trustees.

A combination of statute and case law has articulated this duty, albeit without absolute clarity, to mean:

Fiduciary duty
To act prudently
• Exercise the 'care, skill and diligence' a prudent person would exercise, not just when dealing with their own investments, but when dealing with investments for someone else for whom they feel 'morally bound to provide.
• Apply the special knowledge and experience they possess or, if they are professional trustees, the skills expected of a professional trustee.
• Have regard to the need for 'diversification of investments', in so far as appropriate to the circumstances of the trust.
• Have regard to the 'suitability of each investment'.
• Obtain and consider 'proper advice' on certain matters, such as whether an investment complies with the Statement of Investment Principles required for occupational pension schemes.
• Take account of all relevant considerations and ignore irrelevant considerations.
• Act reasonably.
To act for a proper purpose
• Trustees must also exercise their investment powers for a proper purpose: ie the purpose for which the trust was established. This means for the express purpose stated in the instrument creating the power – the trust deed and rules where they apply.

In the case of the Pension Fund, the 'proper purpose' is ultimately to pay future pension promises to its members, and therefore obtain sufficient returns with which to do so, as set out in the Fund's Statement of Investment Principles:

1. *To ensure that resources are available to meet the Fund's liabilities through achieving investment performance at least in line with actuarial assumptions.*

2. *To achieve full funding (i.e. no funding deficit) over a period no longer than the current recovery period.*

This overriding principle of providing returns for the Fund's beneficiaries has been subject to several notable legal cases as set out below.

Significant case law relating to fiduciary duty

In 1984, a court held in **Cowan v Scargill** that where the purpose of a trust is to provide financial benefits, powers of investment under the trust must be exercised 'so as to yield the best return for the beneficiaries', taking into account risks of the investments in question. In considering what investments to make, in his view, the judge maintained that trustees must put their own personal interests to one side and simply adopt the most 'beneficial' investment.

This decision has since been interpreted by some members of the investment community as imposing a duty to obtain the maximum rate of return possible, effectively precluding trustees and their fund managers and advisers from having regard to any considerations, other than the maximisation of financial returns. This decision, however, predated the provisions of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 as referenced below.

A similar issue arose in **Martin v City of Edinburgh District Council** in 1988. A breach of trust arose since the Council divested from South Africa without expressly considering whether it was in the best interests of the beneficiaries, and without obtaining professional advice. However, the judge expressed the view that trustees did not have an unqualified duty to 'rubber stamp' an investment manager's advice or to invest trust funds in the most profitable investment available.

In addition, **Harries v Church Commissioners (1992)** is relevant in which the court held that excluding investments in certain business activities on ethical grounds could be acceptable where an adequate width of alternative investments remains, but trustees should not take into account such non-financial considerations to an extent which would give rise to risk of significant financial detriment to the proper object of the trusts.

As well as case law, various pieces of research have also been conducted in this area. The law firm, Freshfields Bruckhaus Deringer, commissioned by the United Nations Environment Programme Finance Initiative (UNEP FI) produced what is

considered to be the seminal work regarding the incorporation of environmental, social and governance (ESG) issues into investment risk analyses.

The Freshfields review argues that there are powerful reasons why Cowan v Scargill does not provide good authority for the investment approach that trustees must seek return maximisation at the expense of all other considerations.

Ultimately, Freshfields argued that, no modern court would treat Cowan v Scargill as good authority for a binding rule that trustees must seek the maximum rate of return possible with every individual investment and ignore other considerations that may be of relevance, such as ESG considerations.

The report goes on to suggest pension fund trustees will fulfil their fiduciary duties provided they treat the purpose of the investment power (which for pension funds will ordinarily be to seek a financial return for the beneficiaries) as the primary purpose and, while allowing for the influence of other relevant considerations, do not allow it to be overridden by any other purpose. This means that the consideration of secondary considerations, such as ESG, could legitimately form part of any investment decision as long as they do not override the primary consideration of making a financial return.

Importantly, the assessment of any individual investment should properly include its fit into the investment portfolio as well as its expected return. Considerations such as risk versus return and correlation to the rest of the portfolio are valuable, and it is part of the trustee's role to seek returns across the entire portfolio across a variety of different economic possibilities, rather than on an investment-by-investment basis.

In addition, the fiduciary duties relating to the Pension Fund are enshrined in the relevant regulations affecting such investments as detailed below:

Regulatory requirements

The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378),

The relevant regulations are set out below:

- Regulation 2 (3) (b) (vi) requires Statements of Investment Principles to include the extent (if at all) which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments. (Whilst this did not originally apply to schemes established under enactment, its provision was subsequently included in the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009.)
- Regulation 4(2)(a)states that assets must be invested in the best interests of members and beneficiaries.
- Regulation 4(2)(b) provides that 'in the case of a potential conflict of interest (the assets must be invested) in the sole interest of members and beneficiaries.

- Regulation 4 (3) requires that the powers of investment, or the discretion, must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole.
- Regulation 4(7) states that the assets of the scheme must be properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings and so as to avoid accumulations of risk in the portfolio as a whole. Investments in assets issued by the same issuer or by issuers belonging to the same group must not expose the scheme to excessive risk concentration.

The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 (SI 2009/3093) in relation to ESG within Statements of Investment Principles:

The relevant regulations are similarly set out below:

- Regulation 11 requires an administering authority to formulate a policy for the investment of its fund money, with a view to the advisability of investing fund money in a wide variety of investments; and to the suitability of particular investments and types of investments.

- Regulation 12 states that an administering authority must, after consultation with such persons as it considers appropriate, prepare, maintain and publish a written statement of the principles governing its decisions about the investment of fund money, and repeats at 12(2)(f) the provisions of Regulation 2(3)(b)(vi) referred to above.

In issuing these regulations, the Government did not seek to impose requirements regarding ethical investment, but instead imposed a requirement on administering authorities to include in their statement of investment principles their policy 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*".

Whilst there is, therefore, no regulatory requirement to take into account ESG considerations, the Lancashire County Pension Fund sets out its position via the Statement of Investment Principles, which, is similar to that taken by the majority of LGPS funds.

Lancashire County Pension Fund Statement of Investment Principles

The extent to which the Lancashire County Pension Fund currently takes ESG considerations into account is set out in the following statement contained in its Statement of Investment Principles:

Social, Environmental and Ethical Considerations

The Fund takes an active stance on corporate governance issues. It uses Pensions Investment Research Consultants ("PIRC") to vote on its behalf at shareholder meetings. PIRC advises on Socially Responsible Investment issues and issues voting guidance and commentary for shareholder meetings. PIRC is instructed to vote the Fund's shares in accordance with its guidelines unless an Investment Manager requests a different vote for investment management reasons. In the latter case, the Treasurer to the Fund will decide how best to cast the vote in the long-term financial interest of the Fund.

The Fund is a member of the Local Authority Pension Fund Forum ("LAPFF"), which is a group of like-minded local authority pension funds that meet to discuss and act / engage in respect of Socially Responsible Investment and Corporate Governance issues.

Tobacco

Clearly, equity holdings by the Fund cover a wide range of companies dealing in a wide-range of activities, all of which are lawful. One of the most high profile of these relates to investments in companies from which a significant proportion of their activity is tobacco-related. As at 31 December 2012, equity holdings in tobacco related companies in LCPF accounted for 1.58% of the total Fund, equating to just under £72 million. In addition, fixed income bonds amounting to just over £6 million are held in relation to tobacco companies.

It should be noted, however, that typically these Fund investments are made by investment managers of pooled funds, as well as direct holdings, which the Fund has appointed / invested in. The practicality of seeking to divest or avoid individual share holdings in tobacco or other individual activity within such pooled funds may be difficult.

There has been significant publicity recently regarding the holding of tobacco stocks by Pension Funds with questions raised as to whether this is compatible with other responsibilities held by administering authorities in relation to Public Health.

Local Authority responsibility for Public Health, and Article 5.3 of the World Health Organisation (WHO) Framework Convention on Tobacco Control

There has been much reference to the impending transfer of Public Health responsibilities to local authorities from April 2013 and the potential conflict of interest that this could provide. In particular, Article 5.3 of the WHO Framework on Tobacco Control, to which the UK is a Contracting Party, is frequently mentioned in this context.

Article 5.3 states *"In setting and implementing their public health policies with respect to tobacco control, Parties shall act to protect these policies from commercial and other vested interests of the tobacco industry in accordance with national law."*

This Convention obligation relates to protecting public health policies from commercial and other vested interests of the tobacco industry. This does not translate into a prohibition on local authorities with public health functions from investing pension funds in tobacco companies. The Guidelines for implementation are more specific and refer to public bodies not having financial interests in the tobacco industry. The Guidelines are not legally binding although their recommendations have moral force.

It is clear that the investment of pension funds in tobacco companies (undertaken at the discretion of external investment managers) does not directly permit tobacco industry involvement in public health policy making by the County Council. The nature of the mandates with the Fund's investment managers does not provide for such investment services to provide a route for any influence, direct or otherwise, on Council policy, either from the fund managers themselves or the companies in which they invest.

A similar separation is achieved by the distinct nature and governance arrangements relating to individual Committees of the County Council. Public health arrangements will be governed by a new Health and Wellbeing Board, subject to its own objectives and terms of reference. As such, any investment of pension funds in tobacco interests by the Pension Fund will have no effect or influence upon public health decisions made by the County Council.

In addition, an appropriate separation of functions between its distinct responsibilities, which does exist within the County Council's organisation, addresses any potential conflict of interest. In law, the body that oversees the pension fund must be a committee of the Authority, and not the Executive. Further separation is achieved since none of the County Council's Cabinet Members are members of the Pension Fund Committee.

It is sometimes forgotten however, that the County Council is not the Pension Fund per se, and vice versa. The County Council is the administering authority for the Fund but its responsibility arising from such a role is one of the many responsibilities attributable to it, such as being a Highways Authority etc. Responsibility for public health will soon be added to that list, but these responsibilities are distinctly separate from those relating to the County Council as administering authority for the Pension Fund. With regard to public health, it is noted that many employers represented on the Pension Fund Committee have no such public health responsibilities.

Ultimately, the Pension Fund has a duty to consider the full range of investment options available, and securing an appropriate financial return is the primary objective of the Fund in order to meet future pension commitments. Ethical factors may be relevant as an additional consideration to separate investments with similar

financial characteristics to favour an investment which is viewed as more ethical or socially responsible. The practicality of this, however, is not to be viewed lightly and would require contractual changes in the mandates of fund managers, who currently operate with unconstrained ability to invest, through diversified portfolios, in order to meet the Fund objectives.

The Convention does not impose a legally binding prohibition upon the Pension Fund investing in tobacco companies. In terms of the moral force of the Guidelines, the Council must continue to ensure that there is an appropriate separation of functions between public health policy making and pension fund investment decision-making. Aside from this, members of the Pension Fund Committee are required to act in accordance with their fiduciary duties as referred to above.

The investment policy of the Fund should be guided by the primary purpose of the Fund that investments should be made for the beneficiaries and not made for political purposes. In addition, investment powers should not be used to make moral statements at the expense of the beneficiaries.

Conclusions

Legal commentators have stated that ethical factors may be relevant in pension fund investment decision-making, however, trustees and Fund Managers must not dismiss the possibility of making certain investments because they consider them unethical. They have a duty to consider the full range of investment options available to them and their decision should, first and foremost, be based on the expected investment performance of the asset. Securing a decent financial return in order to meet future commitments to beneficiaries is the primary objective of a pension fund.

In doing so, the assessment of any individual investment should properly include its fit into the investment portfolio as well as its expected return. Considerations such as risk versus return and correlation to the rest of the portfolio are a valuable part of securing returns across the entire portfolio across a variety of different economic possibilities, rather than on an investment-by-investment basis;

Typically these Fund investments are within pooled funds as well as direct holdings. The practicality of seeking to divest or avoid individual share holdings in tobacco or other individual activities within such pooled funds may be difficult, and could have an effect on the overall performance of the Fund.

The County Council is not the Pension Fund and vice versa. The County Council is the administering authority for the Fund but its responsibility arising from such a role is one of the many responsibilities attributable to it. Responsibility for public health will soon be added to its list of responsibilities, but such responsibilities are distinctly separate from those relating to the County Council as administering authority for the Pension Fund.

Article 5.3 of the WHO Convention does not translate into a prohibition on local authorities with public health functions from investing pension funds in tobacco companies. The investment of pension funds in tobacco companies does not directly permit tobacco industry involvement in public health policy making by the County Council. An appropriate separation of functions as set out above should be sufficient to address any potential conflict of interest.

The requirement for Statements of Investment Principles to include reference to ESG considerations, if any, acknowledges that such considerations should be naturally part of an informed investment policy, even if an ultimate decision is made not to specifically divest from certain investment types. It is accepted that ESG issues can affect company performance, and therefore where the pension fund is satisfied as to the financial characteristics of two particular investments, then it could theoretically favour the investment which in its view is more ethical or socially responsible. The practical implications of implementing such a change may be problematical within existing mandates.

Clearly, any ethical restrictions that damaged financial returns could not be justified. However, in comparing potential investment decisions, and where differences in predicted returns are deemed immaterial, ethical considerations could be deployed in deciding upon selection. In addition, ethical considerations may also be valid where it is thought that long-term performance may be enhanced by such consideration.

Judgements arising from relevant case law referred to above make it clear, therefore, that in order to meet its fiduciary duties, the Fund cannot unilaterally decide to divest from an individual investment type without regard to the overall objectives of the Fund, or without taking appropriate professional advice including risk and return considerations.