

ESG

WHERE IS THE ROOM FOR MANOEUVRE?

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ESG – what is it?

- Environmental
- Social
- Governance



ESG – what's the question?

- Question often asked:

Can I / should I take ESG factors into account?

- Answer now (relatively) clear
 - although what that means in practice is another thing
 - and that may not even be quite the right question ...



Trustee investment duties

Three sources:

- Statutory
- Scheme provisions
- Other, ie equity / common law



Trustee investment duties

Statutory:

- PA95, ss33-36
- Occupational Pension Scheme (Investment) Regulations 2005
(note October 2019 amendments)



Trustee investment duties

Statutory:

- Must exercise investment powers with a view to giving effect to the SIP (s36(5))
- SIP must specify policies in relation to:
 - ‘the extent (if at all) to which social, environmental or ethical considerations are taken into account ...’*
 - (reg 2(3))
- Also note reg 4 requirements



Trustee investment duties

Scheme provisions:

- PA95, s34:

The trustees of a trust scheme have, subject to section 36(1) and to any restriction imposed by the scheme, the same power to make an investment of any kind as if they were absolutely entitled to the assets of the scheme.



Trustee investment duties

Other:

- *Cowan v Scargill* [1985] Ch 270
- *Martin v The City of Edinburgh District Council* [1989] PLR 9
- *Harries v Church Commissioners* [1992] 1 WLR 1241
- *MNRPF v Stena Line* [2015] EWHC 448 (Ch)



Trustee investment duties

Other:

- Best interests principle
- Proper purpose principle
- Two sides of same coin
- *'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'*



ESG – traditional approach



- ESG factors effectively ignored
- Seen as irrelevant to investment decisions
- Or even contrary to best interests of members



Developments – 2014 Report

Law Commission Report:

‘Fiduciary Duties of Investment Intermediaries’

- *‘There are no right answers’*
- Core duty to promote trust’s purpose
- Useful distinction between:
 - Factors which increase returns or reduce risk – financial factors
 - Those that don’t – non-financial factors
- Trustees should take ESG factors into account where financially material



Developments – 2015-2016

- Feb 2015 Government consultation
 - Then decided not to do anything
- Sep 2015 Carney speech
 - ‘Breaking the Tragedy of the Horizon’
- Dec 2015 Paris Agreement on Climate Change
- Dec 2016 IORP II Directive:
 - ‘prudent person’ and ‘best long-term interests’
 - *‘within the prudent person rule, Member States shall allow IORPs to take into account the potential long-term impact of investment decisions on environmental, social, and governance factors’*



Developments – 2017 Report



- June 2017: Law Commission Report:
‘Pension Funds and Social Investment’
 - Reg 2(3)(b)(vi) is confusing
 - Conflates social and environmental factors which *‘are usually financial’*
 - With ethical factors which are not
 - As had said before, better distinction between financial and non-financial factors
 - If financially material, trustees should take into account
 - If not then they shouldn’t unless have *‘good reason to think that the membership held values justifying this concern’*
 - And even then *‘the decision should not in any event risk significant financial detriment’*



Developments – 2018

- June 2018 Further Government consultation
- This time they do something
- Sep 2018 Changes to Investment Regs published
 - Effective Oct 2019
 - New Reg 2(3)(b)(vi) and (vii)
 - New Reg 2(3)(c)(ii)
 - New Reg 2(4) – definitions



Developments – 2018

- Reg 2(3)(b): SIP must cover policies in relation to:
 - (vi) 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; and*
 - (vii) the extent (if at all) to which non-financial matters are taken into account in the selection, retention and realisation of investments;*
- Reg 2(3)(c): SIP must also cover policy in relation to:
 - (ii) undertaking engagement activities in respect of the investments (including the methods by which, and the circumstances under which, trustees would monitor and engage with relevant persons about relevant matters).*



Developments – 2018

- Reg 2(4):

For the purposes of this regulation—

...

“financially material considerations” includes (but is 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;

“non-financial matters” means 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;

“relevant matters” includes (but is not limited to) matters concerning an issuer of debt or equity, including their performance, strategy, risks, social and environmental impact and corporate governance;

...



Developments – 2018

- Nov 2018 tPR updated DC guidance:

You should take into account factors which are financially material to the performance of an investment.

Where you think environmental, social and governance (ESG) issues are financially significant you should take these into account.

Likewise if you think certain ethical issues are financially significant.

While the pursuit of a financial return should be your main concern, the law is sufficiently flexible to allow you to take other, non-financial concerns into account if you have good reason to think that scheme members share your view and there is no risk of significant financial detriment to the fund.



Developments – 2018

- Nov 2018 tPR updated guidance:

Sustainability

You should bear in mind that most investments in DC schemes are long term and are therefore exposed to the longer-term financial risks. These potentially include risks relating to factors such as climate change, unsustainable business practices, unsound corporate governance etc. These risks could be financially significant, both over the short and longer term.

- Nov 2018 Updated DB guidance to similar effect



Developments – 2019

- March 2019 – another Carney speech:
‘A New Horizon’
- April 2019 Open letter from Carney et al
- April / May 2019 Fund managers issue warnings
- Extinction Rebellion etc etc



ESG – where are we now?

- Proper purpose / prudent person test
- Distinction ESG / non-ESG not helpful
- Better to consider financial / non-financial
 - an ESG factor could fall into either
- Financial includes returns and risks



ESG – where are we now?

- Relevant circumstances are at time of decision
 - eg current state of climate science
 - eg market attitudes re benefit of ‘greening’ investment
- And include contemporary / changing attitudes to risk
 - eg risk of reputational damage to companies
- May include trustee view as to attitude of members
- Increasing ‘wriggle room’ for trustees?



THE END
(QUESTIONS?)

