LAW COMMISSION

PENSION FUNDS AND SOCIAL INVESTMENT: CALL FOR EVIDENCE

BACKGROUND

1.1 Social investment is an investment which combines financial and social objectives. This idea is that it is possible "to do well and to do good at the same time". As the Financial Conduct Authority (FCA) put it:

> Social investing is a broad concept which at its heart combines the idea that an investment can have a social "impact" or "return" as well as some form of financial return. This social impact or return is usually focussed on a specific issue, geographic area or part of the population, for example, the rehabilitation of offenders or providing training and then employment opportunities for the long-term unemployed….
>
> Social investment is different from charitable giving or making a donation as there is an expectation that capital may be returned and some financial gain could be made.[1]

1.2 The Government is keen to support social investment as a way to access private investment funds to support charities, social enterprises and businesses with a social mission.

1.3 On 3 November 2016, the Minister for Civil Society, Rob Wilson MP, asked the Law Commission to look at social investment by pension funds. How far does or should the law allow pension funds to select an investment because it is thought that it would make a positive social impact? We have been asked to provide an accessible account of the law in this area, and to consider the legal or regulatory barriers to social investment.

The Law Commission's previous work on fiduciary duties

1.4 This project builds on our 2014 report, *Fiduciary Duties of Investment Intermediaries,*[2] which provides guidance to pension trustees on when they can take environmental and social factors into account. The guidance clarifies that pension trustees should take into account factors which are financially material to the performance of an investment, balancing returns against risks. Where trustees think ethical or environmental, social or governance (ESG) issues are relevant to the risks of the investment, they should take them into account.

[1] Feedback Statement FS16/11, Call for Input: Regulatory Barriers to Social Investments (October 2016), paras 1.4 and 1.5.

[2] Available to download from http://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/.

1.5 Although financial return should be trustees' predominant concern, the law is sufficiently flexible to allow other, subordinate, concerns to be taken into account in some circumstances. The law permits pension trustees to make investment decisions that are based on non-financial factors, provided that:

(1) they have good reason to think that scheme members share the concern; and

(2) there is no risk of significant financial detriment to the fund.

1.6 Our 2014 report set out the pensions landscape and summarised the law governing pension investment, looking first at the duties of pension trustees and secondly at the regulation of contract-based schemes. To provide some background to the law in this area, we have provided extracts from our 2014 report in a separate document. It is available at:

http://www.lawcom.gov.uk/project/pension-funds-and-social-investment/.

The next step

1.7 Our fiduciary duties report concentrated on defined benefit pension schemes. It sought, in particular, to provide advice to trustees about when they could or should screen investments that might be regarded as unethical. By contrast, this project is focused on defined contribution pensions, particularly where funds are chosen by the individual concerned. Further, rather than look at negative screening, we ask when pension funds may be invested positively for social good.

1.8 The Social Market Foundation has suggested that all employers should offer defined contribution (DC) savers the option to save in a social pension.[3] It argues that people will be more engaged with saving for a pension (and more inclined to save) if they can see that their money is used for social good. The social element may also provide "counter-cyclical stability": in other words, in periods of recession, when traditional investments do badly, social investments may do well.

1.9 The Foundation draws on the French example of "Solidarity Investment Funds", used for workplace savings. Here up to 10% of funds are used to make social investments in charities, co-operatives and companies with a social mission. The rest is placed in more traditional investments, which are screened for social responsibility.[4] Typically, the social impact portion goes to affordable housing projects, environmental schemes and social inclusion projects, such as those which encourage the long-term unemployed into work.

1.10 We have been asked to provide a report by May 2017.

[3] N Keohane and S Rowell, "Good Pensions: introducing social pension funds to the UK", Social Market Foundation and Big Society Capital, September 2015.

[4] Since 1997, these funds have been awarded the "Finansol" label, to reassure investors that their assets will go to projects with strong social or environmental impact. In 2015, the "Finansol" label was granted to its 144th recipient.

CALL FOR EVIDENCE

1.11 We start with a call for evidence. Below we outline the issues we are investigating and ask questions.

1.12 We welcome responses by **15 December 2016** to:

commercialandcommon@lawcommission.gsi.gov.uk.

DEFINED CONTRIBUTION (DC) DEFAULT FUNDS

1.13 In defined contribution schemes, members may choose how they would like their pension to be invested. However, most people find decisions about pensions to be complex, hard, unpleasant and time-consuming.[5] In practice, most members do not make a choice and are placed in the "default fund".

1.14 Default funds are now subject to a "charge cap" of 0.75%,[6] which has encouraged these funds to adopt low-cost "passive" investment strategies.[7] When coupled with tendency towards "herding" in investment decisions,[8] this may lead default funds to invest in a narrow a range of asset classes. There is relatively little investment in infrastructure, including socially significant infrastructure such as affordable housing.[9] There are many possible barriers to infrastructure investment, including a lack of scale, the need for liquidity, and the demands of regular mark to market valuations.

1.15 We would be interested in receiving evidence on this issue.

Question 1

What are the barriers to pension funds investing:

(a) In infrastructure generally?

(b) In socially significant infrastructure?

(c) In other forms of social investments?

Question 2

Do any of those barriers relate to issues of law and regulation?

5 The Office of Fair Trading has summarised the evidence on this issue: Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014) paras 5.7 to 5.10.

6 This covers administration, investment fees and professional fees but does not include transaction costs.

7 See for example, Defined Contribution Investment Forum, "Mind the Gap: DC innovation under the microscope" (2016).

8 For evidence of herding, see Pensions Institute, "The Market for Lemmings" (2014).

9 The Pension Infrastructure Platform reports just over £1bn investment in infrastructure, well short of the Government's 2011 target of £20bn.

Question 3

Is the size of funds a major issue? If so, are there legal obstacles to scheme mergers?

DEFINED CONTRIBUTION (DC) CHOSEN FUNDS

1.16 Many employers give their employees the option of an ethical pension fund. However, it has been suggested that some of the options are limited. The emphasis tends to be on screening out what are perceived to be harmful stocks (such as armaments), rather than on positive investment for social impact. The journalist, Aime Williams, for example, argues that ethical options may not reflect the values of the "millennial generation": they may put too much emphasis on screening out "sin stocks" such as alcohol and gambling (which younger people do not object to) while leaving those who (in her words) are "tax-dodgers" or "Libor-riggers" or who "pump out fossil fuels".[10]

1.17 Research by the Defined Contribution Investment Forum suggests that younger employees are keen to invest in a pension with a social purpose. Some may be prepared to do this even if the returns are lower.[11]

1.18 We are interested in exploring this issue.

Question 4

We wish to hear from employers and pension providers about the ethical options currently on offer (whether positively or negatively screened).

(a) What ethical DC pension funds are available?

(b) What proportion of people take them up?

(c) What sort of returns do they provide?

Question 5

We seek views about how far these options meet the needs of savers.

(a) Would a greater range of options encourage greater engagement with pension saving?

(b) In particular, would options seeking social impact as well as financial returns encourage engagement?

[10] "Why does pension investing have to be a moral dilemma?" *Financial Times*, 21 September 2016.

[11] For example, in one survey 77% favoured a social fund over a conventional fund if returns were similar; 44% still preferred the social fund, even when they were told that they would receive an 8% smaller pot and 30% stuck with it even when the pot was 18% lower. (Defined Contribution Investment Forum, Identifying new ways to engage with savers in DC pensions, March 2013).

Question 6

We are also interested to hear about the returns available for social investment (intended to have a positive benefit):

(a) Are there sufficient investment opportunities to provide both social impact and market returns?

(b) How far should savers be prevented or discouraged from sacrificing returns for social impact?

THE "SUITABILITY TEST"

1.19 Financial Conduct Authority (FCA) rules require financial advisers to perform a "suitability test" before recommending an investment to clients.[12] In December 2015, the FCA asked whether this or any other specific rules may be hindering investment for social purposes.[13]

1.20 In October 2016, the FCA published its feedback statement, concluding that there was no case for regulatory change. It noted that social impact investing could be risky, describing it as "a form of venture capital, in that investments are made in often small, unlisted companies which can have a high failure rate". Therefore, "the expected social impact may not be achieved and there may be no financial return either".[14] The FCA concluded:

> The social investment market is still in its early stages, and appropriate consumer protections are important if investors are to have the confidence to invest, and if the market is to flourish.[15]

1.21 The FCA received some evidence that financial advisers were uncertain about how to advise clients on the suitability of social investments, as it required exploring clients' motivations as well as financial needs. Advisers also felt hampered by a lack of definitive framework for measuring social impact.

1.22 We would welcome examples of good practice, showing how these issues can be overcome.

[12] FCA Conduct of Business 9 rules.

[13] Call for Input: Regulatory Barriers to Social Investment, December 2015.

[14] Feedback statement FS16/11, para 1.7

[15] Feedback statement FS16/11, para 3.4.

Question 7

In practical terms, how can financial advisers:

(a) best explore their clients' social motivations?

(b) present social investment options in a way that is clear, fair and not misleading?

A COMPARISON WITH FRENCH SOLIDARITY FINANCE

1.23 Social investment through fund structures is much more prevalent in France, where more than 1 million individuals save through schemes with a social investment component.[16] Since 1997, these funds have been awarded the "Finansol" label, to reassure investors that their assets will go to projects with strong social or environmental impact.

Question 9

Should social investment options be labelled or described in a standardised way? Would this be possible given the range of funds which might be regarded by different groups, or in different contexts, as social investment?

1.24 Furthermore, France has a strong social enterprise sector, in which social businesses can pay 50% of profits to shareholders, and reinvest the other 50% for social impact. In England and Wales, the law of social enterprises is complex, with a mix of charities, Community Interest Companies, Co-operative Societies and Community Benefit Societies. The rules tend to be more restricted than in France. For example, Community Interest Companies may pay no more than 35% of profits to shareholders, and must retain 65%.

1.25 Charities are subject to a full asset lock, which requires funds to be used for the charitable purpose – there is no question of paying a profit to shareholders. Large charities are often incorporated, which means that they may take on secured loans, and can even issue bonds. For medium-sized charities, a new organisational form has become popular: Charitable Incorporated Organisations. However, this does not provide the facility for charities to secure loans on anything other than land.

Question 10

Is there a need to review the legal framework around social enterprises, to make it easier for such enterprises to borrow money and receive investment?

[16] Figures provided by Finansol for 2015.

1.26 We also welcome any additional comments you may have beyond the scope of the questions above, particularly where they relate to the legal or regulatory landscape.

7 November 2016