Law Commission

Reforming the law

# PENSION FUNDS AND SOCIAL INVESTMENT: COMPILATION OF CONSULTATION RESPONSES

The following is a compilation of responses to our Call for Evidence on Pension Funds and Social Investment as of 13 January 2017.[1]

Not all of the documents annexed to the responses have been included in this compilation. Two consultees wished for their entire response, and that fact that it was submitted, to remain confidential; accordingly these responses have not been included.

The responses have been redacted in accordance with the Data Protection Act 1998 and for the protection of sensitive and confidential information.

1 Law Commission, Pension Funds and Social Investment Call for Evidence (2016).

# THE LAW COMMISSION

# PENSION FUNDS AND SOCIAL INVESTMENT: COMPILATION OF CONSULTATION RESPONSES

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ARC
Pensions Law

# ARC PENSIONS LAW RESPONSE TO LAW COMMISSION CALL FOR EVIDENCE ON PENSION FUNDS AND SOCIAL INVESTMENT

We are pleased to have this opportunity to contribute to the debate on the possibilities for the greater use of pension fund monies in supporting charities, social enterprises and businesses with a social mission.

ARC Pensions Law is a leading firm of specialist pension lawyers specialising in workplace pension schemes. Our client base consists of Defined Benefit, Defined contribution and Hybrid schemes and their sponsors.

## 1. Executive summary

We recognise the dual challenges of finding suitable investment vehicles for members' pensions savings and securing investment in organisations that have a strong social objective. In principle, there are good reasons why it could be beneficial for these two objectives to be combined, provided that appropriate safeguards are also present. However, we believe that notwithstanding the legal protections that are highlighted in the Commission's paper, there remain legal and practical obstacles that will continue to deter trustees and managers of workplace pension schemes from widespread offerings of such investments.

## 2. Pensions first

We can appreciate the potential benefits both for members and social projects from widening the breadth of investment opportunities with pension scheme monies. However, from both the legal and social perspectives the starting point for any consideration of this subject must be that pension savings are for the provision of retirement-related benefits. Those savings therefore require a high degree of protection, both from loss, and in respect of investment return until they are deployed for the benefit of the aged member.

The protection issue is therefore an important consideration in respect of this consultation. It arguably has a greater impact potential on members in a DC scheme than in a DB one, since in the DC scheme it is the members who are directly impacted by the investment return from their allocated funds, and carry the full investment risk. The impact of these issues on individual members can be reduced through the use of pooled investment funds, which is commonplace. Nevertheless, any reduction in investment return impacts members.

We agree with the conclusions of the Call for Evidence and the backing extracts from the Commission's 2014 Report on the legal position, which counter the popular misconception that investing pension fund monies requires that the best available investment return is sought at all times, to the exclusion of all other considerations. It seems clear that trust law allows trustees, in discharging their duties, to take other issues into account, such as the characteristics, needs and desires of the members. It also seems likely that in the case of contract-based pension arrangements the

managers are in effect also subject to a similar, if not to the same level, duty of care to members.

This flexibility allows for pension savings to be invested in a manner that enables social and environmental matters to be an aspect of the selected investment vehicles, and accepts the possibility of lower potential returns, subject to there being an appropriate interest in those vehicles from the members whose money is being invested.

**3. The potential for member disappointment over outcomes.**

The subtext of any discussion of investment that is focused on a factor other than the achievement of the greatest absolute financial return, is that it is more likely to produce a return that is lower than would otherwise be achieved. This would be regarded as the "cost" to the member of following their social conscience. This is not inevitable, since for a number of reasons such investments can produce superior returns and/or offer the potential for counter-cyclical returns that can complement other investments in the portfolio, as the consultation document acknowledges.

However, the possibility of a focus other than on maximum returns diluting performance should not be ignored. If that occurs, even an informed member may be disappointed, so the member with the customary low level of financial literacy is particularly vulnerable. There is potential therefore for a legal challenge even where an investment has been specifically selected, at least in part, on the grounds of its social credentials, even where this fact has been clearly signalled to members.

This presents a risk for DC scheme trustees and managers, in two areas:

- although the member chooses their own investment strategy, they select from a set of options chosen by the parties running the scheme
- the member will be influenced to a greater or lesser extent by information conveyed by the trustees or manager, even where those parties are merely acting as a conduit.

Nevertheless, some trustees or managers may legitimately feel that they are able to construct an environment in which they can safely offer a specific choice of such investment media to members. In that case, social and infrastructure investment may have a future. Despite that, we suspect that for many trustees or managers the legal protections are still not sufficiently precise for them to feel comfortable with following this route.

**4. Default funds a particular problem**

The risk arguably increases where the investment in question forms part of the default fund, which as the consultation document recognises, is where the large majority of DC members' funds are invested. The low level of financial literacy of most members makes them susceptible to misunderstanding the consequences of an investment that has been selected at least partially on grounds other than securing the largest absolute return. That increases the risk to trustees and managers, through members arguing that their decision (whether passive or active) was not an informed one.

The financial knowledge issue is well known, and despite attempts to improve it, remains stubbornly low. It is unlikely to improve significantly in the foreseeable future. Consequently, without further legal safeguards, those responsible for selecting funds to offer to members, particularly the content of default funds, will be reluctant to take the risk of moving too far away from the comparative safety of funds selected on the basis of expected absolute financial return. This would frustrate the government's policy aim upon which the consultation is predicated.

In the specific context of default funds where the member selects a packaged predetermined blend of funds, the Commission's own background material makes clear that it is legally permissible for trustees to invest member funds in a way that accepts the possibility of lower financial returns where the compensating trade-off is a social or similar benefit. This applies provided they have good reason to believe that members would have an interest in the wider aspects of that benefit and that the financial detriment, if any, is unlikely to be "significant". Although these caveats provide the basis upon which trustees might feel comfortable in including such investments in the default fund, the uncertainties around such things as being able to accurately determine member interest in the facet other than absolute return will again make many trustees reluctant to choose them.

On the other hand, where trustees do feel able accurately to identify the interests of members, this may offer a way forward. Wider governance issues are driving a move away from schemes offering a single, generic default fund for members, towards multiple default funds, designed around segregated memberships. This may provide a limited boost for the inclusion of investments containing a social element, where trustees feel able to more accurately match default funds to relevant members (but see below for impact on investing fund sizes).

Nevertheless overall, as noted above, poor member financial knowledge will in practice continue to be a barrier dissuading trustees and managers of DC schemes from investing in social investments.

## 5. The issue of fund sizes (particularly in respect of infrastructure projects) (Question 3)

Fund size can be an issue. Infrastructure projects of the type for which the government is generally seeking investment from pension funds are too large for any DC pension investor (and indeed, also for most UK DB schemes). In many cases the time lag between the investment and the first returns becoming available is also an issue.

Size per se need not present an insurmountable barrier to investment by smaller investors, provided the project can be packaged and offered on a unitised basis, the individual members' funds are pooled, or both. In principle this is no different from common current practice across the pensions and wider investment industry.

Even where funds are combined in this way, the proportion of an infrastructure project that can be taken by an individual fund is likely to be relatively small. This makes the task of selling the investment effectively more difficult. Partly driven by this, there has been an upsurge in interest instead in finding ways to increase scheme sizes.

However, that may not be as effective in practice as it might appear in theory. In the context of a DC scheme, a default fund should provide a medium for aggregating individual member funds, but the move towards multiple defaults more closely related to the characteristics of particular member groups dilutes that effect.

That leads to the question of aggregating smaller schemes in order to achieve critical mass for infrastructure investing. There are already models for multiple employer schemes, either involving employers within an employer group, or unconnected employers. There are therefore no absolute insurmountable legal obstacles to mergers between DC schemes. There may however be considerable administrative cost implications, and the disinclination of individual employers to give up their own scheme with its close connection with their employees should not be underestimated.

Furthermore, merging existing schemes is a potentially difficult legal undertaking, where individual member consents would be required. This could occur, for example, where the new scheme would not continue with investment funds in which member monies are currently invested. This would not be unusual, given the universe of funds used across the DC scheme spectrum. A key attraction of consolidation is simplification and a consequent reduction of administration costs. If the aggregated scheme would be required to continue to maintain a plethora of old investment funds from past individual schemes due to an inability to obtain individual member consents to change, that element of incentive to consolidate disappears.

It is not uncommon for scheme rules to require the consent of affected members to any change being made. A practical solution might then be to close the current scheme to future contributions and offer instead membership of the new multiple-employer scheme. However, that would provide only a limited solution to satisfying the government's objectives in the short term, as it would take time for the new schemes to build up the accumulated funds of the size being sought for infrastructure investment.

It would of course be possible to legislate to compel schemes to consolidate. We understand that this is a step that has been taken previously in other jurisdictions. However, there will still be technical and moral issues to overcome, and whether or not to proceed along these lines would be a political decision.

## 6. Conclusion

We therefore conclude that, whilst there is potential for matching the government's desire to source new investment for social and infrastructure projects with access to private pension funds, success may continue to be elusive, due to existing legal and financial knowledge constraints. Success in reducing the negative effect of those constraints may involve legislative and/or regulatory intervention. Any such decision would be a political one. The impact on an individual member may be significant and measurable, and it will be essential to incorporate an element of explicit or at least tacit member consent.

**ARC Pensions Law**
**13 December 2016**

**From:**
**Sent:** 10 November 2016 11:13
**To:**
**Subject:** Re: Call For Evidence: Pension Funds and Social Investment

Dear Lucinda,

Thank you very much for contacting me. I believe similar question was partly explored by the Law Commission's Consultation on Fiduciary Duties. My understanding of the key finding in relation to social investment was that the law does not preclude social investment as long as this does not come at the financial detriment to the fund.

I had collected prior academic evidence to suggest that some trustees were uneasy to invest in what they classed as CSR for various reasons.

I have just completed a research study for the FCA, which looks into behavioural biases of the oversight committees, particularly focusing on pension fund trustees, which when published may be of interest.

Best wishes,
Anna

Best wishes,

Dr. Anna Tilba
Director of Corporate Engagement
Lecturer in Strategy and Corporate Governance

http://www.ncl.ac.uk/nubs/staff/profile/anna.tilba

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**From:**
**Sent:** 07 November 2016 15:30
**To:**
**Subject:** Call For Evidence: Pension Funds and Social Investment

**CALL FOR EVIDENCE: PENSION FUNDS AND SOCIAL INVESTMENT**

The Minister for Civil Society, Rob Wilson MP, has asked the Law Commission to look at social investment by pension funds. In particular, how far the law does or should allow pension funds to select an investment because it is thought that it would make a positive social impact?

Today, we issued our **Call For Evidence** and seek your responses by **15 December 2016.**

Law Commission
Tower, 52 Queen Anne's Gate
Westminster, London SW1H 9AG

15th December 2016

**Big Society Capital's response to the Law Commission Call for evidence on pension funds and social investment**

Dear Sir, Madam

Big Society Capital are delighted to respond to the Law Commission's call for evidence on DC pensions and social investment. We believe this is extremely timely given the growing interest and momentum in this areas from government, individual savers, and progressive pension platforms and providers.

There is a significant opportunity to unlock the £500 billion of assets expected in DC schemes by 2030 by allowing savers to make financial choices that align with their values as well as saving for retirement.

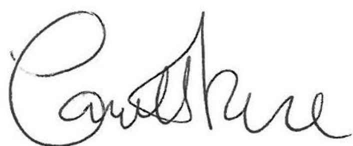
Government can play a key role in supporting this. Our interpretation of the evidence gathered, including legal advice from Sackers, and input from a number of other stakeholders, concludes that there are some legal, regulatory and structural barriers to DC pension funds making social investments.

Based on this, we have made a number of recommendations where targeted policy change could be highly valuable. Our recommendations fall into four themes:

1. **Transparency, disclosure and consultation** – As a first step, we recommend a legal requirement for DC pension funds to disclose the impact of current investments, and to regularly and meaningfully seek the views of members on whether default and chosen options align with their broader values.
2. **Fiduciary duty** – Changes in legislation to give trustees comfort that social investments are in accordance with their legal duties, including the duty to act in the best financial interests of beneficiaries
3. **Liquidity** – Greater clarity is required to overcome structural barriers around investing in less liquid social investments. We recommend an amendment to members' statutory right to request transfers to provide an option to exclude a small, illiquid portion of a fund that could be channelled into social investments.
4. **Accreditation and labelling** – There is a clear role for legal or regulatory backing for an independent body to accredit and label a social pension fund option.

Given the range of barriers above, to address the current inertia we recommend that government mandate all DC pension schemes to offer a 'social' pension fund option. This would have a truly catalytic impact on the market. These recommendations are laid out in detail in the paper, where we have provided responses to all questions raised in the call. If my colleagues or I can expand on these points, or provide more information, please do not hesitate to contact us. We also welcome comments and feedback from other interested parties.

Yours sincerely,



Camilla Parke, Strategy and Market Development Associate, on Behalf of Big Society Capital

**Introduction**

**Big Society Capital is delighted to respond to the Law Commission's Call for Evidence on DC pensions and social investment. Our response has been formed on the basis of reasonable evidence available and our best interpretation of legal advice provided by Sackers, a firm specialising in pension scheme trustees and sponsors. Our response has also been shaped through consultation with a range of stakeholders active in this area including NGOs, think tanks and those working closely with DC pension funds and providers. We welcome comments and input from others on the recommendations outlined.**

**Our response**

**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?**

**Evidence suggests that there are some legal barriers to DC pensions making investments into infrastructure, social infrastructure and social investments. These primarily relate to fiduciary duty and the statutory requirement for members to be able to transfer funds that creates a significant liquidity barrier. There are further regulatory barriers related to liquidity and structural issues that make it more challenging for trustees to invest in assets they are unfamiliar with. However, a number of these barriers can be addressed, and we believe government could play a significant role here to accelerate uptake of social infrastructure and social investment by DC pensions.**

**Defined Benefit Pension funds have been active investors in infrastructure for some time**

Defined Benefit pension schemes have been investing in infrastructure (including transportation, utilities and communications) for many years. Although UK pension funds still invest far less in infrastructure than their counterparts in countries such as Australia and Canada, this is increasing. By 2016, British pension funds had an average of 3.6 per cent of their assets invested in infrastructure, up from 3.2 per cent in 2010[1]. Similarly, social infrastructure (including investment in to schools, hospitals, universities, and prisons) is gaining interest, and government[2] is keen to support higher levels of pension fund investment into these assets, particularly in a low-interest rate environment.

There is also some evidence of more progressive DB pension funds and other institutional investors making social investments, where both investors and users of capital intend to make a positive social impact as well as a financial return. There are a wide range of different forms of social investment, including smaller, more illiquid investments into charities and social enterprises (both directly or through funds), through to larger investment into organisations with a defined social purpose, and investments into public institutions that intend to deliver social impact.

However, to date there are much lower levels of investment into infrastructure and social infrastructure through DC pensions. This is also the case for social investment. The Law Commission has called for evidence on the barriers to DC pension funds making these types of investment. There are some legal barriers to DC pensions engaging in these types of investment. These primarily relate to fiduciary duty and the statutory requirement for members to be able to transfer funds that creates a significant liquidity barrier. There are further regulatory barriers related to liquidity and structural issues that make it more challenging for trustees to invest in assets they are unfamiliar with. We believe this is significant given the growing body of evidence that the Law Commission refers to that suggests that savers are interested in products that allow create social impact and save for retirement.

Both general infrastructure and to a lesser extent, social infrastructure investments have historically been attractive to large DB pension schemes as a way of matching assets with long term pension payment liabilities and as a means of portfolio diversification. Both infrastructure and social infrastructure assets can be listed and unlisted, though a higher proportion of

[1] Data from Preqin, quoted in the Financial Times, https://www.ft.com/content/a05fe960-95ec-11e6-a1dc-bdf38d484582
[2] Insert reference to government support for this

social infrastructure is unlisted, and therefore, less liquid.  The large size of many DB schemes and different draw down requirement means they are able to tolerate this balance and to invest in assets with long term time horizons. Examples of significant investments in these areas include:

- **The Stanhope Pension Trust -** made the first investment of its kind by a UK pension fund in 2014 into a major Scottish road project, arranged by Allianze Global Investors, as part of a £175m total investment
- **Legal & General** - have invested £8 billion in UK infrastructure to date, including direct investments and urban regeneration projects, and aims to invest £15 billion in UK infrastructure in total. Aviva and Legal and General are among six insurers that have agreed to collectively invest £25bn in UK infrastructure over the next five years
- **Multi-Strategy Infrastructure Fund (MPIS) -** aiming to invest a minimum of £2bn into UK infrastructure, of which over £1bn is committed through its indirect investment programme, including the Thames Tideway Tunnel, or London 'super sewer'
- **The BT Pension Scheme –** holds a minority equity stake in Thames Water, and shareholdings in Kemble Water Holdings, which are illiquid inflation-linked investments

**A number of Defined Benefit pension funds are starting to actively engage with social investment**

Investment seen to date by pensions funds in this area has typically been larger-scale social investments that are targeting market rate returns and investments for broader public purpose into organisations intending to deliver social impact. There are broadly three ways pension funds are engaging:

1. **Investments into existing social investment funds** – examples include several pension fund investing into The Cheyne Social Property Impact Fund[3]. The fund's objective is to invest £900 million to increase the capacity of charities and social enterprises that deliver services such as supported housing for people with disabilities, affordable housing for those on low incomes, elderly care and specialised housing for people experiencing homelessness.
2. **Partnerships to identify and assess social investment options** – for example, to realise large-scale community investment opportunities, the £250m Investing4Growth[4] fund was started by five Local Authority Pension Funds working in collaboration to make investments that provide a commercial return and also have a beneficial economic, social or environmental impact. Investments included the Bridges Ventures Social Impact Bond fund.
3. **Setting up new social investment funds** – Greater Manchester Pension fund allocated £150m into an Impact Portfolio (as a follow on from its involvement in Investing4Growth as above), a portion of which was allocated to social investments such as provision of affordable housing.

**A number of barriers exist that are preventing DC pension funds from investing in infrastructure and social investment assets**

Compared with the activity seen to date through DB funds, investment in infrastructure (including social infrastructure) and social investments are not happening at the same scale through DC funds. This is signification given the UK's shift from a largely DB to DC pensions market. There are three types of barriers limiting activity in this areas: legal, regulatory and structural. These are summarised in Table 1 below, and are our best interpretation based on independent legal advice from Sackers (see Appendix 1). A full version of this advice can be found on Big Society Capital's website and is available in request. Given the diversity of assets involved, Table 2 outlines our interpretation of how these barriers may impact different forms of infrastructure, social infrastructure and social investments.

[3] More information available at https://www.bigsocietycapital.com/what-we-do/investor/investments/cheyne-social-property-impact-fund
[4] More information available at http://pirc.co.uk/I4G/files/June2014-Concluding-Statment.pdf

**Table 1: Barriers to DC pension funds investing into infrastructure, social infrastructure and social investments**

| | **TRUST BASED DC** | | **CONTRACT BASED DC** | |
|---|---|---|---|---|
| | **Default fund** | **Chosen fund** | **Default fund** | **Chosen fund** |
| **LEGAL** | | | | |
| **Fiduciary Duty** | Assessment of an investment should be based on consideration as to how its inclusion will service the best financial interest of members.<br><br>In practice, this means Trustees must not consider non-financial factors that do not serve these interests even if members share this viewpoint (reference to the Law Commission's 'Two tests)<br><br>The materiality threshold on the risk of significant 'financial detriment' is very low.<br><br>Trustees are interpreting this in practice as the risk of *any* financial detriment, rather than, as the Law Commission suggests risk of 'significant' financial detriment. This means trustees are highly unlikely to consider non-financial factors at all, even if there is clear member interest and materially very low or no risk of financial detriment. | It is fully compatible with a trustee's fiduciary duty to offer a chosen fund that takes into account non-financial factors.<br><br>This can include investments into infrastructure, social infrastructure and social investments (those that intentionally target social objectives)<br><br>This can include investments that come with the risk of lower than market rate financial return (though inclusion of the above doesn't necessarily mean lower return) - as long as these risks are communicated to members.<br><br>There remains a fiduciary duty to monitor all investments offered and ensure they remain appropriate to members' needs. This may present a perceived structural barriers due to unfamiliarity with social infrastructure and social investment assets | Independent Governance Committees (IGCs), employers and providers each owe a duty of care to members. Issues of fiduciary-like duties apply similarly as they do to trustees, outlined in the left column.<br><br>In practice, it will be very challenging for any parties involved to select a default fund based on criteria that are not in the best financial interests of members, i.e., if there is *any* real or perceived risk of financial detriment<br><br>As described with regard to trust-based default funds (left), parties are interpreting this in practice as the risk of *any* financial detriment, rather than, as the Law Commission suggests risk of 'significant' financial detriment. This means parties are highly unlikely to consider non-financial factors at all, even if there is clear member interest | Fiduciary duty is less likely to be a barrier here<br><br>Again, as with trust-based schemes it is perfectly appropriate for members to be offered funds that specifically take non – financial factors into account, even if there is a risk of financial detriment.<br><br>There remains a duty to communicate this appropriately to members and monitor all investments offered. This may present a perceived structural barriers due to unfamiliarity with social infrastructure and social investment assets |
| **REGULATORY** | | | | |
| **Permitted Links** | This applies to all DC pension fund options offered through an insurance platform. FCA regulation requires that insurers must be able to track the value of a policy by tracking the underlying funds selected by a member. The value of a member's units is derived from assets which are structured as "permitted links", which in practice means those that are 'readily realisable'.[5]<br>Hence, any funds that include infrastructure, social infrastructure or social investments must be structured as "permitted links" to be offered on an insurance platform. These funds may include within their portfolio third party managed funds which are not on their own "permitted links", as long as the overall fund is structured as a "permitted link". This is a complex area of FCA regulation that warrants further clarification in the context of social investments. | | | |
| **STRUCTURAL** | | | | |
| **Liquidity** | There is no explicit regulatory requirement to offer only highly liquid funds in DC pension schemes and in theory, a very illiquid fund should not be inconceivable for a pension scheme saver under normal circumstances.<br><br>However, members statutory rights to transfer benefits when they cease pensionable service with a particular employer (Pension Schemes Act 1993) is a significant barrier to pension funds in holding more illiquid assets.<br><br>A further regulatory barrier is the requirement for platform providers to redeem individuals' underlying linked investments to meet liabilities that may arise. | | | |

[5] See the FCA COBS Sourcebook, Chapter 21 for more: https://www.handbook.fca.org.uk/handbook/COBS/21.pdf

| | |
|---|---|
| **Inertia** | Trustees must consider "proper advice" as to whether an investment is satisfactory under the requirements of the Occupational Pension Schemes (Investment) Regulation 2005. Most trustees will be select pooled funds to which this advice applies. Whilst the need for advice is not itself a regulatory barriers, in practice, most trustees will select established investments which their advisors are familiar with that do not require additional due diligence. This may, therefore, be a perceived barrier with regard to funds that incorporate social infrastructure or social investment assets. |
| **Governance & monitoring** | As above, Trustee fiduciary duties include regularly reviewing and monitor the performance of funds.<br><br>Funds with more 'diverse' objectives, which could include those that may also target social objectives, could be perceived as requiring additional monitoring requirements. This is likely to add an additional cost burden. |
| **Member communications** | There is an obligation on Trustees and contract based providers to ensure that fund descriptions provide a sufficient description of the nature and risk of funds on offer so members can make informed decisions.<br><br>Due to a lack of familiarity with particular social infrastructure or social investments, there may be a perceived barrier in relation to communicating the nature of these funds to members |

**Table 2: Implications for listed and unlisted infrastructure, social infrastructure and social investment assets**

| | **Infrastructure investments** | **Social infrastructure investments** | **Social investments** |
|---|---|---|---|
| **LEGAL** | | | |
| **Fiduciary Duty** | No legal barriers to infrastructure investments provided that inclusion does not present risk of financial detriment (in default fund). | No legal barriers to social infrastructure investments provided that inclusion does not present risk of financial detriment (in default fund).<br><br>Lack of familiarity with these assets may mean trustees are unwilling to include even when material risk of detriment is negligible. | No legal barriers to social investments provided that inclusion does not present risk of financial detriment (in default fund).<br><br>In practice, this is a significant barriers to the making social investments, even those that target market rate returns. |
| **REGULATORY** | | | |
| **Permitted Links** | Underlying assets must be structured as "permitted links" – realisable in the short term. Hence, less of a barriers for listed infrastructure investments. Unlisted investments can be accessed through a "fund of fund" structure if the collective investment itself were structured as a "permitted link" | Underlying assets must be structured as "permitted links" - realisable in the short term. In practice, this is challenging for illiquid, unlisted social infrastructure investments. Investment into these assets would be possible through a "fund of funds" structure if the collective investment scheme itself were structured as a "permitted link" | Underlying assets must be structured as "permitted links" – realisable in the short term. In practice, this is challenging for illiquid, unlisted social investments. Investment into these assets would be possible through a "fund of funds" structure if the collective investment scheme itself were structured as a "permitted link". |
| **STRUCTURAL** | | | |
| **Liquidity** | Infrastructure investments can be both listed and unlisted.<br><br>Infrastructure investments that are illiquid (it is not uncommon for an infrastructure limited partnership to have a 10 or 15 year term during which it cannot be redeemed) can be highly problematic for DC pension funds.<br><br>However, this is a structural barrier than can be overcome through appropriate design of a fund, for example, if overall liquidity can be provided by a majority of a fund that includes a small proportion of illiquid assets. | Social infrastructure investments tend to be unlisted and therefore less liquid.<br><br>Structural barriers related to the liquidity of underlying investments in products listed on DC platform is an issue. However, illiquid assets can be invested into indirectly through collective investment schemes that bundles these assets with liquid ones.<br><br>A significant barrier is the statutory requirement for members to be able to transfer funds. | Some social investment assets (social property, listed charity bonds) are liquid. Other are less liquid, for example, direct investments into charities and social enterprises.<br><br>Structural barriers related to the liquidity of underlying investments in products listed on DC platform is an issue. However, illiquid assets can be invested into indirectly through collective investment schemes that bundles these assets with liquid ones.<br><br>A significant barrier is the statutory requirement for members to be able to transfer funds. |

| | | | |
|---|---|---|---|
| | A significant barrier is the statutory requirement for members to be able to transfer funds. | | |
| **Inertia** | As listed infrastructure investments are likely to be more familiar to trustees, providers and investment managers, less likely to be a barrier | In practice, social infrastructure investment assets (particularly the smaller, less liquid types) are less familiar to trustees, providers and investment managers. | In practice, social investment assets (particularly the smaller, less liquid types) are less familiar to trustees, providers and investment managers. |
| **Governance & monitoring** | As listed infrastructure investments are likely to be more familiar to trustees, likely to be less concerns around additional monitoring requirements | As above, this may lead to real and perceived barriers around additional monitoring and diligence requirements. For smaller funds, the possibility of additional costs associated with diligence and monitoring may be a barrier. | As above, this may lead to real and perceived barriers around additional monitoring and diligence requirements. For smaller funds, the possibility of additional costs associated with diligence and monitoring may be a barrier. |
| **Communications** | As above, unlikely to be a significant barrier | As above, trustees and providers may require more support to effectively communicate the nature and risk (where relevant) of funds that include social infrastructure investments.<br><br>A lack of familiarity with impact measurement and reporting may also be a barrier. | As above, trustees and providers may require more support to effectively communicate the nature and risk (where relevant) of funds that include social investments.<br><br>A lack of familiarity with impact measurement and reporting may also be a barrier. |

**Government could play a role in addressing a number of these barriers to support the development and uptake of a social pension for DC funds in the UK**

Government has expressed interest in enabling DC pensions to make social investments in the UK. A potential structure that has been put forward by Big Society Capital is replicating the '90/10' solidarity employee savings schemes in France within the UK pensions context. This option is described in detail in the paper *Designing a Social Pension Investment Fund for UK pensions*, but could practically involve 90% of a fund investing in listed assets that meet ESG criteria and up to 10% investing in social investments, which could be a mix of larger liquid social investments into public purpose assets (such as social infrastructure) that target market rate returns, and more illiquid smaller scale social investments (such as indirect investments into charities and social enterprises).

Based on the analysis above, we would suggest that under the current legal and regulatory regime, it would be practically very challenging for either trust or contract based schemes to offer such as proposition through a default fund, even if there was compelling evidence to demonstrate member demand for such a product (referencing the Law Commission's 'Two tests' that must be satisfied for non-financial factors to be taken into account by trustees). In practice, trustee interpretation of the law means there it be very challenging for non-financial factors to be taken into account when choosing default fund investments, as trustees are unwilling to risk the potential for any financial detriment to the fund. In the case of social investments, though there are a significant volume of assets that, we believe, would not pose the risk of financial detriment, in practice, unfamiliarity with these assets combined with personal liability means trustees are unlikely to consider proposition that includes social investments.

There would appear to be fewer legal barriers to such an option being offered as a chosen fund, though structural barriers remain.

We would therefore make the following recommendations to government to support the development and uptake of such a fund in the UK:

| Problem | Recommendation |
|---|---|
| **Fiduciary duty with regard to default fund**<br>In practice, it is very hard for trustees to take into account non-financial factors even if there is clear evidence of member interest, if there is *any* degree at all of possible risk of financial detriment. This could prevent trustees from choosing a default option where a small proportion of the fund was invested into social investments, even if these targeted market rate returns. | 1. Changes in legislation to give trustees and ICGs comfort that social infrastructure and social investments are in accordance with their legal duties, including the duty to act in the best financial interests of beneficiaries<br>2. Clarify through legislation or statutory guidance how Trustees may interpret the risk of 'significant financial detriment'. |
| **Chosen funds**<br>There appear to be no legal barriers to chosen funds being offered where a portion of the fund could be placed in social investments, regardless of whether this involves the risk of financial detriment to the member (as long as the natural of the fund is properly communicated and suitability monitored)<br><br>Indeed, there is a degree of risk to trustees if they do not provide chosen funds that reflect the views and needs of members. Yet, chosen funds of this nature are currently unavailable in the market when evidence suggests there is consumer interest in these propositions. | 3. Requirement in law for DC pension funds to disclose the impact of underlying investments to The Pensions Regulator<br>4. Requirement in law for trustees to regularly and meaningfully seek the views of members with regard to how funds are invested<br>5. Terms of Reference for Independent Governance Committees should be broadened and clarified by the FCA to require the consultation of members, and that ICGs hold Boards to account for this<br>6. Requirement for member representation on governance Boards |
| **Liquidity barriers**<br><br>The requirement for member to be able to quickly transfer funds is a significantly liquidly barrier to funds investing in illiquid assets<br><br>Further, regulation around permitted links in the context of social investment are unclear and given there is no legal requirement for DC funds to only invest in liquid assets, more could be done to enable funds to be structured to incorporate illiquid assets. | 7. Amend statutory regulation to include the provision for individual to 'opt in' to accept lower liquidity on a portion of their fund to achieve social aims<br>8. Clarity around the application of FCA regulation on "permitted links" in the context of DC pension funds making a range of different social investments. This may include the permission for a small proportion of a social pension fund to be invested in illiquid social investments, provided that the remainder of the fund can provide adequate liquidity.<br>9. Consider ways to encourage the provision of liquidity through third parties for potentially small portions of funds invested in illiquid assets |
| **Inertia**<br>Continued inertia driven by a trustee and investment managers lack of comfort with social infrastructure and social investment, compounded by regulatory and structural barriers above | 10. Requirement in law for all DC pension schemes to offer a 'social' pension fund option |

It is worth noting that in the case of '90/10' solidarity employee savings schemes in France, a number of structural approaches have helped addressed the liquidly challenge of a small proportion of funds being invested into illiquid solidarity enterprises. Firstly, the French Financial Markets Association (AMF) that regulates all financial products, recommends that asset management companies have contracts in place with third parties (banks or stockbrokers) to guarantee the liquidity of unlisted securities. For example, Ecofi Investissements has such a contract with the Credit Cooperatif for its solidarity investments.

Secondly, as the number of assets under management in these '90/10' funds has increased, asset managers have moved towards centralising all solidarity investment into single financing vehicles, the composition of which is regulated by the AMF. These funds must have a minimum of 35% of assets in solidarity companies and a minimum of 30% in listed monetary assets. This scheme allows better liquidity management of the more illiquid solidarity based securities.

Question 3: Is the size of funds a major issue? If so, are there legal obstacles to scheme mergers?

**Aside from very small schemes (where certain regulatory requirements do not apply), it appears that scheme size of itself does not creates any material difference in fiduciary or regulatory barriers to investment in infrastructure, socially significant infrastructure or other forms of social investments.**

However, larger trust-based scheme with significant assets in the default fund may be better placed to tolerate some illiquidity in relation to a small proportion of its assets and still be able to maintain liquidity at an overall fund level sufficient to satisfy member transfer requests promptly. Similarly larger schemes are likely to have trustee boards capable of devoting greater time and expense overcoming inertial and governance issues which may be disproportionate for a smaller scheme. Indeed, research by Share Action suggests that the size of a pension scheme is a strong indicator of good outcomes for beneficiaries. Schemes must operate at scale to ensure adequately skilled governing bodies, sufficient internal support and to access economies of scale and better bargaining power.[6]

| Problem | Recommendation |
|---|---|
| The process of scheme mergers itself has been identified as difficult | 11. Consider how scheme mergers could be simplified. If there is interest in accelerating uptake of social investment through DC schemes, consider whether this could be incentivised by simplifying merger processes for those funds offering a social pension option |

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?

**Publically available information on uptake and the returns of 'ethical' funds is limited which makes it challenging to assess the current landscape of market provision. Given the importance of this, we could recommend that The Pensions Regulator formally requests the employers and providers supply information on the range of 'ethical' options available, their targeted returns, up take and member engagement.**

There are a growing number of 'ethical' pension funds on offer. However, what is described as and constitutes an 'ethical' fund varies widely. Three broad groups of 'ethical' investment strategies are outlined below and evidence suggests that these funds can outperform those that do not employ these strategies.

While there are (helpfully) a growing number of pension fund options that integrate environmental, social and governance (ESG) criteria to enhance value, there are no options currently available that direct a portion of the fund to intentionally create positive social impact. As identified by the Law Commission, there is a growing body of evidence to suggest that individuals are interested in pension propositions that not only screen out certain investments, but that positively target the positive social outcomes. We believe this represents a significant gap, where savers are not currently being provided with choices to meet this expressed need.

**Current options available adopt a number of Socially Responsible Investment (SRI) strategies**

[6] http://shareaction.org/wp-content/uploads/2016/01/ReducingRegulationReport.pdf

What is often called an 'ethical' fund in the market is a one that adopts some form of SRI strategy. According to Eurosif, the UK is Europe's largest SRI market with a total of £10.2bn now being managed in this kind of product in the UK.[7]

Sustainable and Responsible Investment (SRI) incorporates any strategy an investor may deploy which incorporates Environmental, Social and Governance (ESG) consideration or analysis. These ESG issues may be incorporated in a variety of ways, and for simplicity, these can be grouped into broadly three buckets, outlined below. It is important to note that funds available in the market tend to adopt a mix of investment strategies across these:

- **Exclusions and norms-based screening** – those that exclude specific investments or classes of investment from the investible universe such as companies, sectors or countries, which may be based on moral or ethical criteria, or that do not comply with international standards and norms. One could also include emerging approaches such as Sharia pension funds[8] within this group, as these funds will only invest in companies confirmed as being Sharia compliant and this typically involves the exclusion of certain industries and companies.
- **ESG integration and 'best in class' approaches** – those that incorporate social, environmental and governance risks (ESG) into their investment decisions to help to protect value. 'Best in class' funds deeply integrated ESG factors into their investment analysis and proactively select companies that they believe will outperform the market because they operate (or have the potential to operate) in a more sustainable way than their peers over time
- **'Low carbon' or environmental approaches**- also known as 'sustainability themed' investments including 'low carbon' funds.

The range of approaches that can be taken by 'ethical' funds highlights the necessity for clear, transparent and accessible information to be presented to savers to allow them to make informed choices. An example of good practice is NEST which offers an 'Ethical' investment fund. The information provided to potential savers clearly defines the investment approach, including the material difference in the way in which the fund interprets the terms 'ethical' and 'responsible' investment, and how this defines the investment strategy in practice[9].

Publically available information on uptake and the returns of 'ethical' funds is limited. However, evidence suggests that funds that integrate ESG criteria outperform those that do not. In the UK, the Environment Agency DB Pension Fund that has taken a rigorous approach to ESG integration, and proactively invested into areas such as sustainability property and social infrastructure and out-performed its benchmarked by an average of 8.9% over the past 3 years.[10] Internationally, Sustainable pension funds on offer within Sweden's Premium Pension System (PPM) have had both higher returns and lower fees on average in the last five years than other funds[11]. The average return for M/E-labelled funds (funds that take environmental and/or ethical considerations) in the last five years is 5.5% compared with 4.1% for other funds.

In terms of uptake, we have heard anecdotally that the uptake of NEST's 'Ethical' Fund is low. There are likely to be a number of reasons for this, including low levels of engagement overall with options outside of the default fund which is a broader consideration. There also appears to be a lack of awareness of options amongst savers: a Good Money Week poll found that 54% of the GB public is unaware that sustainable and ethical financial products exist, rising to over 63% among millennials (18-34 year olds).

| **Problem** | **Recommendation** |
|---|---|
| Publically available information on uptake and the returns of 'ethical' funds is limited | 12. The Pensions Regulator formally requests the employers and providers supply information on the range of 'ethical' options available, their targeted returns, up take and member engagement. |

[7] https://www.trustnet.com/News/616147/fe-research-the-ethical-funds-that-advisers-should-be-looking-at
[8] Examples of Sharia Funds include NEST Sharia Fund that invests in larger global companies that comply with Sharia principles. Vodafone offer employees a DC Sharia Fund that invests in the HSBC Life Amanah Pensions Fund.
[9] For more on the NEST ethical fund, see https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/NEST-ethical-fund-brochure.pdf
[10] https://www.theguardian.com/sustainable-business/environment-agency-pension-fund-responsible-investment
[11] https://www.ipe.com/news/esg/sustainable-funds-outperform-with-lower-fees-says-swedish-pensions-agency/10015309.fullarticle

**There remains a gap in the market for a 'social' pension option that intentionally targets the creation of positive social impact**

As above, we are not aware of any existing DC pension products available in the market that allow savers to make social investments whilst also saving for retirement.

There is, however, evidence of interest in such a product. Research by the Defined Contribution Investment Forum[12] found that 77% of individuals favoured a social pension fund over a conventional fund if the returns were similar; 44% still preferred the social fund, even when they were told that they would receive an 8% smaller pot, and 30% agreed even if the pot was 18% lower.

**Question 5: Would a greater range of options encourage greater engagement with pension saving? In particular, would options seeking social impact as well as financial returns encourage engagement?**

**In principle, we believe it is important for savers to have access to choices that meet their needs and the capacity and information to make an informed choice that is right for them. Whilst there are a range of 'ethical' options available to savers, there are currently no products that allow savers to make social investments that generate positive social impact and income in retirement. In this sense, we do not feel savers currently have access to the right options to meet their expressed desired. We believe that savers are more likely to engage with choices they feel reflect their broader values.**

The extension of pension flexibilities means savers in the UK have greater choice over how to access their pension than ever before and the shift from DB to DC schemes and auto-enrolment places much greater onus on the individual to engage with these choices. Though there are currently no such pensions options available to savers, there is evidence from parallel markets to suggest consumers engage more (and practically pay more) for choices that create social impact. It is therefore not unreasonable to assume that a social pension option could encourage broader engagement with savings.

**There is some international evidence that over time greater focus on individual choice can support higher engagement**

There is some international evidence that over time as savers have greater choice and agency over their pensions options their engagement with their pension increases. Across countries, general levels of saver engagement with their pensions is low, but Australia is a notable exception. The Australian DC system is characterised by high levels of flexibility for savers, and has been for the past 20 years, unlike in the UK where flexibility is reasonably new. It has been suggested that one of the factors contributing to this engagement is that Australian employees typically choose their own pension provider, which creates significant focus on individual choice. Further, evidence both from Australia and the UK is that as members' pot size increases, the engagement levels also grow.[13] Though it is challenging to compare the UK with other international models based on very different contexts and cultural attitudes towards savings, there does appear to be evidence that over time in pensions markets where there is greater onus on the individual, this may lead to higher levels of engagement.

**Consumer behaviour in parallel markets suggests socially motivated behaviours can be self-reinforcing**

Currently in the UK, there are no options for DC pension savers to positively target the creation of social impact whilst also delivering an income in retirement, which means there is no direct evidence that such an option would increase engagement. There are, however, three areas of evidence that point to how this may link to broader pension engagement:

- Evidence from Share Action indicates that greater transparency around where pensions are invested can increase member engagement[14]

[12] Defined Contribution Investment Forum, Identifying new ways to engage with savers in defined contribution pensions (March 2013)
[13] DCIF Engagement Barometer 2016, see http://www.dcif.co.uk/resources/
[14] Governance and administration of occupational defined contribution trust based schemes, response prepared by Share Action, Jan 2016. Accessed here: https://shareaction.org/wp-content/uploads/2016/04/CR-1.pdf

- Anecdotal evidence from Canadian pension funds indicates that those that actively communicate their ESG stance to members have higher engagement levels[15]
- Wider consumer evidence from parallel markets that suggests consumers are willing to change their buying behaviour to make positive choices that reflect their values. Data from Nielsen shows that almost two-thirds (66%) of consumers are willing to pay extra for products and services that come from companies who are committed to positive social and environmental impact.[16] Similarly, research from the US has shown that consumers are pay more at the point of purchase for Fairtrade products because they align with their values[17].

Based on these proxies, it is not unreasonable to think that financial options (including savings and pensions) that align with individuals broader values could prompt them save more.

**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?**

**Yes, based on our analysis of the social investment market in the UK, we believe there are at least £67.4bn of social investment assets suitable for pension fund investment that are targeting market rate or close to market rate of return and delivering social impact.**

Big Society Capital's recent paper 'Designing a social investment fund for UK pensions' explores the current universe of social investment assets that could be suitable for investment through pension funds. As referenced in this paper when considering the potentially investable universe, it is important to draw the distinction between 'Socially Responsible Investment[18]' assets and those that can be considered 'high impact' assets that generate positive social impact. Within this are social investments – where both investors and users of capital intend to make a positive social impact. SRI investments tend to be in listed companies, whereas social investment covers a range from smaller-scale, less liquid investment to larger scale listed investments.

The table below outlines different social investment assets in the UK that are targeting or achieving close to or market rate returns that could be suitable for pension fund investment.

| **1. 'Established' investments achieving market rate returns**<br>Relatively more 'established' social investments and investments into large social assets that have demonstrated track record of targeting and achieving market rate or close to market rate returns, examples include: | | |
|---|---|---|
| **A sset type** | **Market size (stock, mn)[19]** | **Typical targeted rate of return** |
| **Housing Association bonds (some listed) and secured commercial loans**<br>Raising long term capital for the development and maintenance of social housing | £59bn | Typically 1.5-2.5% higher than inflation linked gilts, zero-default record |
| **Charity Bonds (listed and unlisted)**<br>Charities financing investment needs through the issue of bonds, larger-scale listed bonds (>£10m) can be issues to retail investors | Charity bonds (listed and unlisted) total: £6.5bn, of which £6.4bn are large listed Charity Bonds | Listed retail charity bonds typical range 4 – 4.5% coupon<br><br>Example of an unlisted bond, Golden Lane Housing £10m issue of unlisted 5 year bond at 4% |
| **2. Emerging investments targeting market rate returns** | | |

[15] Based on conversations with UN PRI around the experience of signatories
[16] http://www.marketingcharts.com/traditional/will-consumers-pay-more-for-products-from-socially-responsible-companies-60166/
[17] https://www.gsb.stanford.edu/insights/jens-hainmueller-will-consumers-actually-pay-fair-trade
[18] The Principles of Responsible Investment defines 'responsible investment' as "an approach to investment that explicitly acknowledges the relevance to the investor of environmental, social and governance factors, and of the long-term health and stability of the market as a whole. It recognises that the generation of long-term sustainable returns is dependent on stable, well-functioning and well governed social, environmental and economic systems."
[19] The size and composition of social investment in the UK, Big Society Capital, available here: https://www.bigsocietycapital.com/sites/default/files/attachments/The%20size%20of%20and%20composition%20of%20social%20investment%20in%20the%20the%20UK_3.pdf

| | | |
|---|---|---|
| Investments still establishing track record, but are targeting close to market rate returns, examples include: | | |
| **Equity like-lending**<br>Small and medium sized charities and social enterprises taking on 'quasi-equity' growth capital | £32m | Information not publically available but will be targeting close to market rate |
| **Green bonds**<br>Bonds issued by large companies where proceeds are used for environmental purposes | £1.6bn | Average yield 1.5 – 2% (for a 5.5 year bond with AA rating)[20] |
| **3. Higher risk investments targeting close to market rate returns**<br>Currently accounting for approximately half of Big Society Capital's current investment portfolio. These assets tend to have a higher financial risk profile and as yet, limited track record of return | | |
| **Social Impact Bonds**<br>Payment by results models that enable social organisations to deliver an innovative social service for the public sector. | £14m | Target range 5 – 15%<br>By example, The £25m Bridges SIB fund targeted a return of 5% a year.[21] |
| **Social property**<br>Investment made to finance the purchase and operation of properties that service the social sector and local authorities, often providing affordable housing and/or housing for those with specific needs. | £130m | Target net return:<br>Levered funds 10-12%<br>Unlevered funds 5 – 7% |
| **SME charity debt**<br>Small and medium sized charities and social enterprises, unsecured loan finance | £158m | Target net return:<br>Secured – 3 – 6%<br>Unsecured – 8 – 10% |

There are also a range of investments into assets through public institutions targeting close to or market rate returns, that may not be considered to be social investment as defined above, but are serving a broader public purpose. These include:

- Local Authority Bonds (£850m)
- Quasi- government bonds (£8.5bn)
- Social infrastructure (£57.7bn)

Based on the above, we can estimate that there are approximately **£67.4bn** of social investment assets suitable for pension fund investment that are targeting marker rate or close to market rate of return and delivering social impact. This is significantly higher if the three buckets above are also included. We believe this is sufficient to support the setup of new funds, however in the longer-term, a deeper pool of investable assets will be needed

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

Based on the information provided above, it is important to note that making social investments does not necessarily require financial returns to be sacrificed. As described above, there are a range of social investments that are targeting market rate returns, some of which are likely to be more appealing to institutional investors including pension funds. Similarly, there are social investments, particularly more illiquid, riskier smaller-scale investments into charities and social enterprises that may not target or deliver market rate returns.

In practice, there is evidence that there are savers and investors who are prepared to accept a lower than market rate financial return to make an investment that aligns with their broader values. In the UK, the largest ever survey of those currently holding 'positive' savings or investments indicates that 48% would be prepared to achieve lower financial returns in order to achieve a 'positive' investment objective, rising to 64% of those under the age of 30[22]. This is significant when considered that 75% of this group overall say more than half of their wealth is currently held in 'positive' savings and investment. Similarly, evidence from Barclays[23] suggests that there are a portion of individuals for whom giving up a degree

[20] Green & Sustainable bonds: growth with staying power?" Natixis, 01/12/14.
[21] http://www.thirdsector.co.uk/social-impact-bond-fund-give-returns-5-year-says-antony-ross-bridges-ventures/finance/article/1311812
[22] Research conducted by Ethex no behalf of the Social Investment Research Council. Sample size 2001 individuals, 2016.
[23] https://wealth.barclays.com/content/dam/bwpublic/global/documents/wealth_management/wp-a-behavioural-framework-for-impact-investing-and-philanthropy.pdf

of financial return to create social impact is in itself intrinsically motivating, and the idea that 'social good is costless' may actually remove their motivation for engaging in this behaviour.

The motivations of individual saves and investors are clearly highly complex, and we are still relatively early in our understanding of these motivations. For example 70% of individual currently using their money this way say that savings or investing positively is part of their overall commitment to living responsibly, whereas 25% are motivated by their religious beliefs. The important point is that individuals should have the opportunity to choose whether or not to sacrifice financial return for social impact if this aligns with their values and is the right choice for them.

In order to realise this, individuals must first have access to the products that allow them to align their financial choices with their values, and secondly to information that is 'clear, fair and not misleading', as required by the FCA, to make informed choices.

**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?**

Currently, suitability is often understood and interpreted by financial advisers and managers in purely financial terms. This leads to poor outcomes for consumers and the misallocation of capital[24]. To properly understand a client's financial situation and investment objectives, it is necessary for advisers and managers to understand a range of non-financial factors, including: (a) whether the relevant client wishes to screen out investments which might have a negative social and/or environmental impact; (b) whether the client wants investments with a positive social and environmental impact; and (c) the relative importance of social and environmental impact as against other traditional financial factors, including return, risk and liquidity.[25]

A recent FCA consultation on regulatory barriers to social investment concluded, based on the responses from a number of financial planning firms and advisors, that there were no regulatory barriers to advising clients on social investments. However, it is clear that those firms who do advise clients on social investment believe this requires a different conversation exploring client's motivation as well as their financial needs. For evidence of how this is being achieved in practice, we would highlight the extensive efforts made by Worthstone, the leading independent social impact investment resource for financial advisers, to support and empower advisors to advice clients on social investment where suitable.

Worthstone regularly convene financial advisors and wealth managers with policy makers and regulators to explore barriers, emerging issues and share best practice[26]. Worthstone have made great strides here, including the launch of an accredited Adviser Competency Training for social investment that received the support of the Minister for Civil Society, Rob Wilson, at its launch at the Social Investment Academy in March 2016[27]. Examples of high level syllabus topics can be found in Appendix 2.

A number of case studies provided on the Worthstone website outline the practical approach taken by a Financial Advisor to understand their clients social motivations and when suitable advise them on a social investment. A persistent barrier for financial advisors is the possibility of complaints to the Financial Ombudsman Service relating to social impact concerns and this remains an area of concern. However, we welcome the recommendation outlines in the FCA's response to the consultation to work with the Financial Ombudman Service to carry out a communications programme targeted at social investment stakeholders, explaining how the Financial Ombudsman Service's rules apply in this particular contest.

[24] http://www.bwbllp.com/file/fca-call-for-input-submission-of-bates-wells-and-braithwaite-london-llp-14-3-16-pdf
[25] http://www.bwbllp.com/file/fca-call-for-input-submission-of-bates-wells-and-braithwaite-london-llp-14-3-16-pdf
[26] Reference to the Worthstone Social Investment Academy
[27] http://www.worthstone.co.uk/news-thoughts/government-announces-fca-accredited-social-investment-training-initiative-for-advisers/

For additional context on this area, we would highlight Law Commission to the following reports:

- Research published by Worthstone into the barriers which prevent investment advisors from recommending social investments, 'Financial planners as catalysts for social investment', published by NESTA.[28]
- The findings of an expert working group 'Advising clients on social investments and deciding on suitability', a report published by Worthstone, in partnership with Big Society Capital and BWB[29]
- The FCA's Call for Input: Regulatory Barriers to Social Investments, sections 2.20 – 2.38, pp 10 -13.[30]

**Question 8. 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?**

**Yes. In principle, our view is that the independent accreditation and labelling of social investment options that intentionally set out to generate social impact alongside financial return, if structured and governed appropriately, could bring three benefits to the market; specifically:**

- **increasing the confidence of investors that the choice they are making is transparent and that their savings or investments are channelled into genuine social investments**
- **supporting and encouraging the development of best practice with regard to the provision of social investment options**
- **providing a degree of consistency and certainty for the regulator (as well as for investors)**

A number of voluntary codes already exist to increase the accountability and transparency of Socially Responsible Investment (SRI) options. These include the UN PRI code with more than 1600 asset manager, investment manager and service provider signatories, and the Eurosif Transparency Code that has been made a mandatory requirement by a number of national SRI labels in Europe, and currently covers more than 500 funds and 50 signatories[31].

We believe there is demand from a range of stakeholder for a labelling or accreditation approach that applies to social investments:

- **Individual savers and investors**: A survey of 2,000 UK investors showed overwhelming support for the introduction of a Kitemark-style label to help them identify which financial products operate in a sustainable or ethical way. In total, 63% of the UK public supported the proposition and 43% said it would make them more likely to buy a financial product, rising to 53% of 18- to 24-year-olds[32]. Survey data from employees saving into the solidarity saving schemes in France suggested that the guarantee of the social use of funds provided by the Finansol label is one of the top two reasons for employees saving through these vehicles.
- **Government:** To provide clarity and transparency in this relatively new form of investment and trust
- **Mainstream financial institutions**: Aviva CEO Mark Wilson recently publically called for 'establishing a Responsible Investment Standard' – a "Fairtrade for Finance"[33] so that fund managers can demonstrate their credentials as responsible investors
- **Social investment intermediaries**: Triodos Bank has publically welcomed the introduction of a kite mark-style scheme to help people easily invest their money in ways that are "good for people and the planet" and have called for all major players in the UK financial system to work together to make this happen.[34]

[28] 'Financial planners as catalysts for social investment' by Anthony Elliott, Gavin Francis and Geoff Knott, NESTA, 2012
[29] http://www.worthstone.co.uk/adviserarea/assets/pdfs/Advising_clients_on_social_investment_-_deciding_on_suitability.pdf
[30] https://www.fca.org.uk/publication/feedback/fs16-11.pdf
[31] https://www.eurosif.org/transparency-code/
[32] Good Money Week poll, http://blueandgreentomorrow.com/news/public-call-financial-kitemark-help-identify-sustainable-financial-products/
[33] http://www.aviva.com/media/thought-leadership/money-talks-how-finance-can-further-sustainable-development-goal/
[34] Quoted here: http://blueandgreentomorrow.com/news/public-call-financial-kitemark-help-identify-sustainable-financial-products/

There is also the argument that give the relatively nascent stage of the social investment market, there is value in the development of an accredited label to build investor confidence and support the development of best practice.

**The solidarity savings scheme in France provides a strong model for a successful accreditation and labelling approach**

This system has three component parts:

*Figure 2: Accreditation and labelling of solidarity funds in France*

The French approach to accreditation and labelling provides a good lens through which to consider how a similar system might work for the social investment options in the UK.

Below, we consider the different possibilities for where accreditation and or/ labelling could be applied, with example of other frameworks that adopt these approaches.

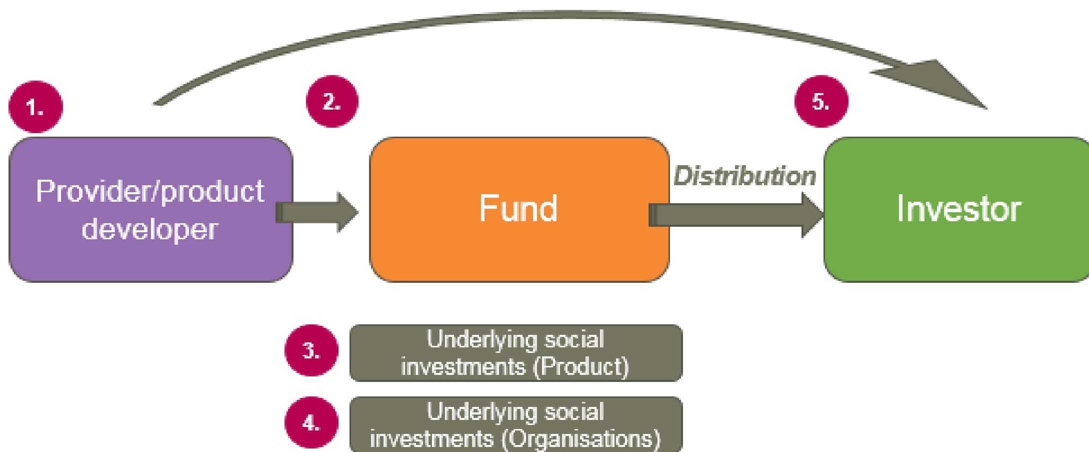



*Figure 3: Options for social investment accreditation in the UK*

| OPTION | | EXISTING EXAMPLES | ASSESMENT |
|---|---|---|---|
| 1. | Provider/ product developer | **Finansol label** in France labels solidarity saving and investment products or funds. However, award of the label also requires product providers to demonstrate consideration of additional factors, such as appropriate management fees, and the method of selecting underlying investments. It also requires that the provider make available up to date data on underlying investments and uptake. However, Finansol does not label an association, a company or a financial institution as a whole. | Pros - Could be suitable for providers that only offer social investments<br><br>Cons - Likely to be highly challenging in practice for individual providers to receive accreditation, when one provider is likely to offer a range of different products. |
| 2. | Fund | This is typically where the majority of forms of labelling and accreditation of ethical or sustainable savings and investment products sit**,** for example:<br><br>**Finansol Label** in France, labels individual solidarity savings products or funds that are accredited by the French Financial Markets Regulator<br>**The FNG Label** is a quality standard for sustainable mutual funds that covers German speaking countries. The Label's minimum requirements consist of transparency and process criteria[35] and adherence to standards set by the UN Global Compact with regard to sustainable investment<br>**The Climate Bond Standards Board**[36] verifies that funds are used to finance projects and assets that deliver a low carbon economy<br>**The Green Bond Principles** are voluntary process guidelines that recommend transparency and disclosure when issuing Green Bonds | Pros - Track record of existing accreditation schemes that demonstrate different approaches and frameworks for establishing independent and credible process standards and accreditation criteria.<br><br>Cons – diversity of different social investment assets and product/ channels would make it challenging to develop an all-encompassing framework for social investments |
| 3. | Underlying investment (into an organisation) | **In France,** the government accredits solidarity organisations, based on a defined set of criteria | Cons – to an extent, legal form already acts as a form of accreditation, with regulated social sector organisations recognised in law as impact-creating organisations |
| 4. | Underlying investments (into a specific product) | **Community Shares Standards Mark** – awarded to organisations issuing Community Shares for direct investment by individuals that meet criteria that ensure the quality and integrity of a share offer. The assessment is carried out by a licensed practitioner.<br><br>**Threadneedle Social Bond Fund** – the partnership with social investment intermediary Big Issue Invest, with a long-established record in managing social investments, provides assurance on the social impact of the bond fund. | Pros: Could work for specific types of assets (e.g., social bonds)<br><br>Cons: Highly complex, for example, to accredit or label the underlying social investments in a fund that could include highly diverse social investment assets |
| 5. | Investor | Potential for self-certified "social investor label"<br>Some evidence from Barclays identified that certain types of social investors derive personal satisfaction from doing social or environmental good[37] | Pros: Evidence to suggest some individual may be motivated by self-identifying as a social investor<br><br>Cons: Could be challenging from an investor protection point of view |

**We recommend the following approach in the UK:**

**Structure and criteria**

In principle, we would recommend accreditation of social investment funds that are then labelled by an independent body. Fund accreditation could be based on the proportion of underlying investment that are channelled into social investments. In practice, this could include regulated social sector organisations, and broader social purpose assets.

[35] https://www.eurosif.org/fng-label-2017-first-signs-of-a-positive-impact-on-sustainable-investment-funds/
[36] https://www.climatebonds.net/standards/certification/get-certified
[37] Barclays, The Value of Being Human: A Behavioural Framework for Impact Investing and Philanthropy September 2015

There is value in maintaining separation between the accreditation and labelling bodies, though an alternative structure could include accreditation and labelling carried out by an independent body with legal and regulatory backing.

**Dual criteria around transparency and proportion of the fund channelled to genuine social investments**

Again, a UK model could replicate the framework developed in France:

- Transparency – a requirement for social fund providers to provide regular information to savers/ investors, and any labelling body
- Social investments – a requirement for a social fund option to invest a minimum threshold of assets in social investments

If a social pension proposition were developed, where a portion of the fund was channelled into social investments, labelling options would include:

- A label on the social pension fund level
- A label on the 'social' portion of the fund (likely to be less than 10% of assets).

**Governance**

Any set of accreditation criteria and the award of any label should be carried out by an independent committee (as with Finansol) with members from across the social and mainstream investment market with a depth and breadth of relevant knowledge. This committee could include representation from Big Society Capital. Independence will bring credibility and trust alongside relevant expertise. Governance should ensure that the accreditation system and criteria are proportionate and cost efficient.

| Problem | Recommendation |
|---|---|
| Need for accreditation and labelling of social investment options to give confidence to investors and reduce the risk of 'social washing' | 13. Consider whether the FCA could provide regulatory backing to empower and independent body to accredit and label social pension fund options |

**Building a pathway over time**

Given the diversity of social investment assets a labelling or accreditation system should start with certain types of assets first, to establish a pathway for clear and credible labelling – for example, on social property funds. Once established and understood by investors and the market, labelling for more diverse, illiquid and potentially higher risk social investment products or funds could be considered. It is important to acknowledge that social investment assets are diverse. What constitutes a social investment to one investor may not to another investor. This is why transparency must be a central tenant of any labelling system. Access to clear, accurate and accessible information on where funds are invested and on the criteria and basis of any labelling system will improve the chances that investors are able to make informed choices that align with their values.

**A number of challenges would need to overcome for any accreditation system to be successful**

Though the comments above provide a very high level sense of how a labelling or accreditation system could work in practice, a number of potential challenges emerge from this that require further detailed consideration:

- **'Ticking the ethical box'** - with regard to a label for a social pension fund closely aligned to the 90/10 structure outlined, there is the risk that having chosen such as fund (most likely as a 'chosen' fund) trustees feel they have 'ticked the ethical box' and as a result do not need to further of fully engage with ESG risks that may be considered both ethical issues and issues that have a material financial impact.
- **What is a social investment** - How easy will it practically be to deem 'what is social'? To an extent, this will always be up to the investor, but in early stages of market, a kitemark or label could build early confidence and credibility to grow engagement
- **Market development** - The social investment market is moving very fast - any accreditation will need to accurately reflect market practice to ensure it remains robust and relevant

**Question 9 (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?**

**Yes. It is our view, alongside others including Bates Wells & Braithwaite London, that the policy context and regulatory framework for the social economy in the UK is fragmented and in places, inconsistent. This is an area that has been explored in some detail elsewhere, however, we highlight two areas below where intervention may still be required: firstly, the need for a 'Social Economy Commission' as the principal regulator of the social economy, with a policy and regulatory brief spanning as far as possible across the social economy. On this point, we agree with recommendations made by Bates Wells & Braithwaite London [38]. Secondly, we highlight the need for a Register of Charges for Charitable Incorporate Organisations to make it easier for these organisations to raise the finance they require.**

**A 'Social Economy Commission' is required to act as the principal regulator of the social economy**

The social economy is incredibly diverse in legal status and legal form. The social economy comprises charities (which in turn come in a number of legal forms), co-operatives, community benefit societies, community interest companies, companies limited by guarantee, companies limited by shares with a social purpose, unincorporated associations and many others. There is neither one Government department nor one registrar or regulator of legal forms which has responsibility spanning the range of organisations in the social economy in the UK. For example, Community Interest Companies (CICs) have a CIC Regulator, whilst the FCA acts as registrar for Co-operatives and Community Benefit Societies.

The Government should convert the Office of the Regulator of Community Interest Companies into a 'Social Economy Commission', as the principal regulator of the social economy, with a policy and regulatory brief spanning as far as possible across the social economy.

The Social Economy Commission should be the registrar and regulator of community interest companies, co-operatives and community benefit societies. In time, the Social Economy Commission could also be given responsibility for the registration and regulation of Social Investment Vehicles and of Social Purpose Businesses or other social purpose organisations, if introduced. It would be a repository of deep and wide regulatory and policy knowledge with respect to the social economy as a whole.

For a more detailed explanation, please refer to 'Ten reforms to grow the social investment market', Bates Wells & Braithwaite, 2012'.

**A register of charges for CIOs would make it easier for them to access appropriate finance**

Charitable Incorporated Organisations (CIOs) are becoming more popular as a legal form for registered charities. All CIOs must be registered with the Charity Commission but does not have the income threshold, allowing for smaller organisations to gain funding. Unlike other legal forms of charities a CIO cannot exist as an entity without being registered with the Charity Commission. 2,016 CIOs were registered in 2014, making up 41.4% of all charity registrations in England and Wales during the year.

Having its own legal personality should make it easier for CIOs to hold property, employ staff and enter into contracts, however, the Charity Commission does not maintain a public register of charges (and there is no other searchable public register of charges which apply to CIOs) which may adversely affect the ability of CIOs to borrow money. This means that CIOs are unable to register a charge (as security provided for a loan) on any publically available register, apart from land that can be registered on the Land Registry. In practice, this makes it very challenging for CIOs to take on secured loans.

[38] See 'Ten reforms to grow the social investment market', Bates Wells & Braithwaite, 2012. Available here: http://www.bwbllp.com/file/bwb-20ten-20reforms-20to-20grow-20the-20social-20investment-20market-20july-202012-pdf

Without a public register of charges, it is very hard for investors to determine what other security might have priority over theirs. This acts as a perceived barrier and can make it more challenging for CIOs to access secured investment.

| Problem | Recommendation |
|---|---|
| The regulatory framework for the social economy in the UK is fragmented and in places, inconsistent | 14. Establish a social economy commission to act as the principal regulator of the social economy |
| Lack of public register of charges may make it difficult for CIOs to access certain types of finance | 15. Make a provision in CIO legislation for the maintenance of a register of charges |

**Appendix 1**

## Social Investment

Legal advice on barriers to investment

### Introduction

We have been asked to provide a legal commentary to Big Society Capital on the barriers that exist in relation to investment by pension funds in social investments.

This note sets out our factual advice on the barriers, based on the current legal framework around pension fund investment. We give our assessment of the legal barriers which we believe exist and a brief commentary on the non-legal barriers so far as we are aware of them.

We do not comment on matters of policy or make any recommendations for policy changes in relation to the barriers that may exist. We are, however, happy for Big Society Capital Limited to use this advice as a legal background to inform their views and to enable them to make their own recommendations on matters of policy.

### A. Questions 1 and 2

What are the barriers to DC pension funds investing:

(a) in infrastructure generally?

(b) in socially significant infrastructure?

(c) in other forms of social investments?

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

### A.1 Background

A.1.1 We consider that a there are a number of barriers to pension funds investing in these areas. Some of these are legal and some are not. We consider that the barriers to investment from a legal perspective can be grouped as follows:

- Fiduciary duties
- Regulatory barriers

A.1.2 In sections A.2 to A.5 below we set out in further details how these barriers manifest themselves in relation to infrastructure generally; socially significant infrastructure; and other forms of social investments. We approach this from the point of view of different types of pension schemes – specifically, trust based and contract based defined contribution ("DC")

pension schemes. The law also applies differently to default funds offered by DC schemes, compared to member chosen funds.

A.1.3 In addition to the legal barriers identified, there are a number of potential structural barriers to investment. These are beyond the scope of our legal advice. However we provide a general commentary on our perceptions in this area as they apply to this question in section A.6 below. Broadly our observations as to the main structural barriers to investment are as follows:

- Pricing and liquidity constraints
- Inertial barriers
- Governance budget
- Member communication difficulties

## A.2 Fiduciary duties – trust-based schemes (general)

**Financial best interests**

A.2.1 Pension trustees have a fiduciary duty to invest pension trust assets in the best interests of scheme members and beneficiaries.

A.2.2 In July 2014, the Law Commission published its report on the Fiduciary Duties of Investment Intermediaries. Among other things their report made clear that, in a pension scheme context, a trustee's core duty is to promote the purpose for which the trust was created – namely, to provide pensions and therefore to act in the best "financial interests" of the scheme's beneficiaries. We agree with this assessment of the legal position.

A.2.3 It remains important, however, to consider this duty in context. Trustees are required to balance returns against risk when investing trust assets and the best financial interests of a pension scheme's beneficiaries are not to be equated with simply "maximising returns".

A.2.4 Trustees should first consider what they are trying to achieve with a particular strategy or portfolio, and only then consider how the financial interests of the scheme's beneficiaries are best served in relation to that strategy. The objective of the strategy will dictate what is financially relevant to the selection of an appropriate investment to deliver on that strategy. This might be anything from outperforming an index to hedging against a risk such as changes in the rate of interest or inflation. The objectives are also unlikely to be the same throughout a pension fund's investment portfolio. Different parts of the portfolio may have different objectives and strategies at different times.

A.2.5 Once trustees have determined their objectives, investment decisions taken (e.g. the selection of an investment) need to distinguish between those factors that are financially relevant to the decision and those which are not. In selecting investments trustees should take account of any factor which is financially material to the performance of the investment. Performance in this context might include return or management of an identified risk. Factors to be considered may include environmental, social and governance ("ESG") factors pertinent to the investment as a financial proposition. It should be noted that ESG factors in this context are about improving financial outcomes for the beneficiaries: they are not about ethical preferences.

**Non-financial factors**

A.2.6 In its report on the Fiduciary Duties of Investment Intermediaries the Law Commission also considered the extent to which other factors might be taken into account by trustees making investment decisions. Among other things the Law Commission concluded that:

- "purely ethical" concerns, designed to show moral disapproval of activities, may only be taken into account if two conditions are satisfied. Firstly, the trustees must have good reason to think that scheme members would share the ethical/moral view. Secondly, they should anticipate that the decision will not result in material financial detriment to the scheme.
- "quality of life factors" (that is, factors relating to beneficiaries' quality of life now and in the future) may only be taken into account when choosing between two equally beneficial investments. They may not be taken into account when this would result in a lower return.

## A.3 Applying fiduciary duties to DC trust-based schemes

A.3.1 For trust based schemes which provide defined benefits, the trustee duty is to invest the scheme's assets appropriately to pay the scheme's promised benefits. However, in a DC scheme, the objectives are more subtle and may best be thought of as having two key components:

- to establish a default fund appropriate to the needs of the membership, keeping this under review and updating it as necessary, and
- to ensure an appropriate choice of investment arrangements ("chosen funds") for those members who do not wish to invest in the default arrangement.

**Default funds**

A.3.2 In relation to a default fund, traditionally trustees will have aimed to provide a fund which provides investment growth in relation to the member and employer contributions made in order to provide a sum of money for a member which can be used to provide him or her with a retirement income. A common approach was to invest for growth in the years furthest from retirement (when greater volatility can be tolerated) and gradually transition to more stable investments that expose a member's accumulated capital to less volatility as the member gets closer to retirement age.

A.3.3 Since the recent introduction of greater pension flexibilities, however, not all pension scheme members can be assumed to be investing for an "income" in retirement. Trustees must therefore consider the needs of their membership and determine what the purpose of the default fund is to be in relation to their particular scheme.

A.3.4 As noted above, once the objectives have been determined the trustees must select an appropriate investment fund or a combination of funds to comprise the scheme's default fund. In making that selection the trustees may take account of any factor which is financially material to the objectives they have set.

A.3.5 Trustees of defined contribution schemes must consider whether a given investment will serve the financial best interests of a pension scheme member in order to include such an investment in a default fund.

A.3.6 Whilst this does not of itself rule out an investment in infrastructure, socially significant infrastructure or any other forms of social investments, the test must always be met in relation to the investment that its selection as part of a scheme's default fund must be on the basis that it will serve the best financial interests of the scheme's members.

A.3.7 It may therefore not be helpful to say that fiduciary duties will always be a barrier to the inclusion of infrastructure, socially significant infrastructure or other forms of social investments in a default fund. Indeed in defined benefit schemes trustees have successfully invested in infrastructure (and socially significant infrastructure) for many years in a manner entirely consistent with their fiduciary duties to invest in the best financial interests of the scheme's beneficiaries.

A.3.8 Instead we think the issue is more subtly put as follows: trustee fiduciary duties may preclude them from some types of investment where those investments pursue social objectives which introduce a financial downside to the

investment that would not otherwise exist and where the trustees could invest in a similar fund that did not have such a downside.

A.3.9 However, as noted above, what should be considered as a "financial downside" is not simply a matter of looking at returns. Trustees must consider their objectives and consider financial issues in the context of those objectives. Within a growth part of a default fund fiduciary duties would preclude the trustee selection of a social investment which in part sacrifices return as part of its objectives. However, within the part of a default fund which aims to expose a member's accumulated capital to less volatility (e.g. as the member gets closer to retirement) a targeted lower return may be acceptable from an investment, if it has other objectives that are financially attractive to the member from a risk reduction point of view and where those objectives are equally capable of being met from a fund pursuing social objectives as one which is not. On this point we do not comment on whether social investments might be constructed in such a way. Merely we seek to point out that the assessment of whether a social investment is in members best financial interests or not must be considered within the context of the trustees' investment objective for the relevant aspect of the default fund.

**Chosen funds**

A.3.10 Although the trustees' legal duty is to act in members' best financial interests when investing on their behalf in the default fund, when members make their own investment choices they are not quite so constrained. As the Law Commission noted in its report, members may legitimately decide to sacrifice some income in old age for ethical concerns. Provided that decision is fully informed, trustees cannot be criticised.

A.3.11 It is therefore perfectly appropriate for trustees to include funds for members to select which specifically take non-financial factors into account, even at the risk of financial detriment to the member.

A.3.12 On that basis we do not consider that trustee fiduciary duties will preclude trustees from offering infrastructure, socially significant infrastructure or other forms of social investments within a range of investment choices for member chosen funds even where those funds include some financial downside as a result of the particular investment objective pursued.

A.3.13 However, again the position is not a completely black and white assessment. The fact that an investment is member chosen does not absolve trustees from fiduciary duties in respect of it. Trustees remain responsible for monitoring all investments offered to their members and ensuring that they remain appropriate to their members' needs. Trustee fiduciary duties include regularly reviewing the performance of chosen funds used by members against their performance objectives and industry benchmarks where available. If funds are not performing trustees should consider changing them.

A.3.14 Again this fiduciary duty does not preclude trustees from offering infrastructure, socially significant infrastructure or other forms of social investments. However, it does introduce a practical issue in that the more funds are offered and the more diverse their objectives, the greater the burden of monitoring them is likely to become. Greater care will also need to be taken in member communications to ensure that members are fully informed about the nature of an investment which run a risk of financial detriment to the member.

A.3.15 We note these below as a potential structural barriers in section A.6 below.

**Financial detriment**

A.3.16 As noted above, trustees should not take factors into account which they consider will result in material financial detriment. We have been asked to comment on what is likely to be "material" in this context.

A.3.17 In the context of a DC default fund we consider that the threshold is likely to be extremely low.

A.3.18 In a defined benefit scheme with large assets and a strong employer covenant, it may be possible to identify some issues as financially immaterial from an investment point of view. However, in a DC scheme where member's benefits are directly correlated to the size of their investment fund we do not consider that trustees should seek to rely on this as

justification for a particular approach. In other words, where trustees have a choice of investments we would not consider it appropriate to select the one which they consider to be worse as a financial proposition simply on the basis that they do not consider it to be much worse.

**The views of members**

A.3.19 As noted above, generally speaking, non-financial factors unrelated to risks, returns, or the interests of beneficiaries should be ignored by trustees in their investment decision making. However, the law does offer some flexibility for trustees to take non-financial factors into account where two tests are met:

- the trustees must have good reason to think members will share the viewpoint, and
- the decision must not risk material financial detriment to the pension scheme.

A.3.20 The former point can be problematic in relation to ethical and moral issues, where the ethical view of members may vary. It may therefore be difficult for trustees to have confidence that members will necessarily share a common view. However, within the context of social investments, arguably trustees may feel more confident in making that assessment without the need for extensive survey evidence.

A.3.21 As the Law Commission observed, trustees may look for good infrastructure schemes which will both improve quality of life and provide good financial returns. And where two projects appear equally beneficial, trustees may choose the investment which will most improve beneficiaries' quality of life. This is on the basis that it may be reasonable to conclude that most scheme members would support such an objective welcoming the lifestyle benefit.

A.3.22 However, in any event financial considerations (to pay retirement and other benefits) must be the primary objective. For the default fund, the trustees' assessment of an investment should be based on their consideration as to how its inclusion will serve the best financial interests of the scheme's members. If it does then the trustees may properly consider it as a potential component of their default fund. If it does not they must not.

A.3.23 For the reasons set out above we consider that that is the more likely barrier to social investments as far as fiduciary duties are concerned.

A.3.24 In relation to chosen funds, trustees merely need to form a view on whether the members are likely to want such a fund. But here the fiduciary duty might be considered in reverse. If trustees were to offer a fund that members did not want (and consequently did not chose to invest in) there is unlikely to have been any breach of fiduciary duty. By contrast not making funds available where there is a clear member desire for them is probably the greater legal risk.

## A.4 Fiduciary duties in contract based schemes

A.4.1 Group personal pensions are increasingly used by employers instead of trust based arrangements. The fiduciary duties of the parties involved in contract based pensions, however, are less clear than for trust based schemes.

A.4.2 Typically an employer will choose the scheme and may make arrangements to collect and pay contributions on behalf of members. However, in legal terms, the scheme is characterised as a contract between each employee and the pension provider. Beyond its initial selection, the employer will have only a limited role in the ongoing monitoring of the scheme. Since April 2015, FCA rules also require firms that operate workplace personal pension schemes to establish and maintain Independent Governance Committees (IGCs). The role of an IGC is to act independently of their pension provider and scrutinise the value for money of the provider's workplace personal pension schemes, taking into account transaction costs, raising concerns and making recommendations to the provider's board as appropriate.

A.4.3 The extent to which employers, IGCs and providers themselves each owe a fiduciary duty to pension scheme members is debatable, although it is clear that each owes a duty of care to some extent.

A.4.4 The issues covered in section A.3 above in relation to the inclusion of infrastructure, socially significant infrastructure or other forms of social investments in a default fund are therefore likely to be similar between contract-based and trust based schemes – i.e. it will be difficult for any parties involved to select a default fund based on criteria which are not in the best financial interests of the scheme's members.

A.4.5 However, in relation to the provision of a range of chosen funds, fiduciary duties are less likely to be a barrier. Provided an employer has made a suitable range of investment options available to its employees the duties can probably be considered to be limited to:

- an obligation on providers to ensure that fund descriptions provide a sufficient description of the nature and risks of each of the funds on offer in sufficient detail to enable a member to take an informed decision whether or not to choose it; and

- an obligation on IGCs to ensure that funds offer value for money to members.

We do not consider that either of these would be a barrier to the provision of infrastructure, socially significant infrastructure or other forms of social investments within a range of investment choices for member chosen funds in a contract-based scheme.

## A.5 Summary of potential fiduciary barriers

| | **Potential fiduciary barriers** |
|---|---|
| **Default Fund** | Assessment of an investment should be based on consideration as to how its inclusion will serve the best financial interests of the scheme's members.<br><br>A.5.1 This is likely to act as a barrier to some forms of social investment which specifically sacrifice return or introduce greater financial risks in exchange for the furtherance of a social aim. |
| **Chosen Funds** | Funds may be offered which specifically take non-financial factors into account, even at the risk of financial detriment to the member.<br><br>**A.5.2** However, care must be taken in member communications to ensure that members are fully informed about the nature of the investment. Trustees will also remain responsible for ongoing monitoring of funds offered.<br><br>**A.5.3** Whilst not a barrier to social investments, these points would need to be taken into account in practice. |

## A.6 Regulatory barriers

**Pensions Investment**

A.6.1 Regulation 4 of the Occupational Pension Schemes (Investment) Regulations 2005 requires trustees to invest in members' best interests. This is backed up by a number of further requirements including express obligations to:

- invest in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole;
- invest in a manner appropriate to the nature and duration of the expected future retirement benefits payable under the scheme;
- invest predominantly in regulated markets and only prudently outside such markets
- to ensure that the assets of the scheme are properly diversified avoiding excessive risk concentration.

A.6.2 It would be possible to discuss at length the extent to which Regulation 4 qualifies or adds to a trustee's fiduciary duties but, in this context, we think it is enough to note that the obligations are broadly consistent.

A.6.3 The application of these rules to a member chosen DC arrangement is not entirely straightforward. In the DC context, the Trustee is usually only in control of the fund choices on offer. It may not have the power to control the members' allocations to those funds. Accordingly, if a member chooses to invest all of their assets in one fund they may well not be properly diversified. The Trustees are, in our view, properly discharging their obligations by applying these regulations within the context of the investment decisions they have.

A.6.4 We do not see anything in these regulations which would prevent the offering of a social fund as a member chosen fund provided the scheme's offering as a whole meets the regulatory requirements and subject, of course, to clear labelling. We return to the requirement to provide appropriately liquid assets below under section A6.

**Permitted links**

A.6.5 Defined contribution schemes are typically offered through an insurance platform. The platform allows the member (whether directly or through a trust based scheme) to access particular funds offered under the platform.

A.6.6 Insurers achieve this by writing linked business. The member (or scheme) will have an insurance policy with the insurer. The value of the policy tracks the underlying fund or funds selected by the member. Insurers are only permitted to write this sort of business where the value of the member's units is derived from assets which are "permitted links".

A.6.7 Managers operating social funds will need to structure their collective investment schemes to be "permitted links" if they are to be offered under defined contribution platforms under the current regime. This may prove challenging in practice for collective investment schemes structured along the models we have typical seen for private equity or infrastructure. This does not, of course, mean that collective investment schemes which are themselves "permitted links" might not include within their portfolios third party managed funds which would not be permitted links on their own account (for example a "fund of funds" type arrangement).

## A.7 Structural barriers

**Investment in illiquid assets**

A.7.1 There is no explicit regulatory requirement to only offer highly liquid funds in DC schemes. In practice, however, Trustees will want to make sure that members are only invested in assets which are sufficiently liquid to ensure that the Trustee can fund transfer requests or member liabilities which occur before retirement age.

A.7.2 A key issue in this context is that most members will have a statutory right under the Pensions Act 1993 to transfer their DC pension pot to another registered pension scheme (see A.7.5 below). Such transfer requests usually have to be satisfied within 6 months.

A.7.3 Some of the investment strategies contemplated within the "social" bracket (particularly those with an infrastructure slant) are likely to be offered by managers who operate in what can loosely be described a private equity or infrastructure model, by which we mean the funds are typically structured as follows:

- at subscription, investors commit to meet draw down requests up to a specified amount. Minimum commitments of at least £10 million usually apply.
- Up to 100% of the commitment is drawn down on an as-needed basis during a specified investment period (typically 2 to 5 years) as and when investment opportunities are identified by the manager.
- The fund will only begin distribution towards the end of its term which could be 10 or 15 years.
- During the term, an interest in the fund cannot be redeemed and a secondary market cannot be assumed.

A.7.4 This structure is not problematic for larger DB pension schemes, where illiquid asset classes will form part of a diversified long term strategy for the scheme as a whole and where the large sums of money required to make capital commitments on this scale are available.

A.7.5 However, DC pension schemes and funds with this drawdown and distribution profile are not structurally well matched. In practice this sort of fund is not directly available on DC platforms. There are two elements to this:

(a) The member and employer contribution stream received by a DC pension scheme must be invested as soon as possible to maximise the investment return for the member. This sits uncomfortably with the draw-down process outlined above which requires large lump sum payments at irregular intervals.

(b) In theory a very illiquid fund should not be inconceivable for a pension scheme saver who might expect to be saving over the long term in normal circumstances. However pension scheme trustees or providers need liquid assets to meet liabilities that arise outside the typical run of events:

- Early retirement/Ill-health/serious ill health/death –members typically have the ability to bring their pension into payment before their normal retirement age from the age of 55 or earlier if they suffer ill health. On serious ill-health, the entire benefit may be payable as a lump sum. A cash lump sum or pension will typically also become payable to a members' dependent on the member's death.
- Transfer values – As noted above, most members will have a statutory right under the Pensions Act 1993 to transfer money purchase benefits from a DC Pension scheme to another registered pension scheme. This may be in addition to any transfer right under a schemes rules. Such transfer requests usually have to be satisfied within 6 months.

In the DC context, these liabilities will need to be met by liquidating the member's units. Assuming the Trustee has offered the scheme through a typical investment platform, the platform provider will have the right not to redeem units if it is unable to redeem the underlying linked investments. This would put the Trustee in the invidious situation of having an obligation to the member without available assets to meet that obligation.

A.7.6 To manage these issues, in our experience, DC Trustees only access illiquid strategies indirectly. They may choose diversified or multi-strategy collective investment schemes where illiquid elements are bundles with other assets to keep illiquidity at prudent levels (see also the restrictions on "permitted links" mentioned above under paragraphs A.5.5-7 above).

This will, of course, result in additional fees and expense and have consequences for the investment characteristics of the asset.

A.7.7 We have been asked to consider the proposal of a “90/10” fund (a “**90/10 Fund**”) in the context of liquidity, by which we understand a (probably) member chosen DC social fund with the following features:

- 90% of the 90/10 Fund’s assets chosen to target on a traditional risk adjusted return;
- the remaining 10% will have an overt social objective which might result in a lesser return.
- for the purpose of this example, we assume that some or all of the 10% is invested in infrastructure or private equity equivalent assets which are very illiquid (it is not uncommon for an infrastructure limited partnership to have a 10 or 15 year term during which it cannot be redeemed. A secondary market may not be available.)
- We have assumed that the 90/10 Fund can be structured to qualify as a “permitted link”.

A.7.8 If a DC member chose to invest all or part of their pension in the 90/10 Fund and subsequently chose to transfer, that transfer request would need to be met from the 90% portion. As long as the 90/10 Fund has sufficient scale, such redemptions should be unproblematic. However, without such scale, it might prove difficult to maintain the 90/10 balance over time.

**Inertial barriers**

A.7.9 Section 36(3) of the Pensions Act 1995 requires that before investing in any manner (other than in a manner mentioned in Part I of Schedule 1 to the Trustee Investments Act 1961) trustees must obtain and consider "proper advice" on the question whether an investment is satisfactory having regard to the requirements of the Occupational Pension Schemes (Investment) Regulations 2005, so far as relating to the suitability of investments, and to the Scheme's Statement of Investment Principles.

A.7.10 This only applies if the Trustee itself is making the decision to invest, not if a manager makes the decision under a discretionary mandate. However, in most cases trustees of trust-based DC arrangements will be selecting pooled funds to which the advice requirement will apply.

A.7.11 The need for advice is not of itself a regulatory barrier to the selection of infrastructure, socially significant infrastructure or other forms of social investments within a DC scheme. However, in practice, our experience is that most trustees (particularly of smaller schemes) tend to select established investments with which their advisers are familiar and can recommend without having to do extensive and bespoke due diligence. There may therefore be considered to be an inertial barrier to new investment products which are not mainstream.

**Governance budget**

A.7.12 As noted above, trustee fiduciary duties include regularly reviewing the performance of chosen funds. The more funds are offered and the more diverse their objectives, the greater the burden of monitoring them is likely to become. In relation to social investments, where the objectives may be more complex than simply generating a return above a benchmark, we consider that the monitoring obligation may be perceived as an additional burden. For smaller schemes with limited governance time, this may be a perceived barrier.

**Member communication difficulties**

A.7.13 As noted above, there is an obligation on a contract-based provider to ensure that fund descriptions provide a sufficient description of the nature and risks of each of the funds on offer in sufficient detail to enable a member to take an informed decision whether or not to choose it. Although this is a specific requirement under FCA Rules for providers in

contract-based schemes, fiduciary duties in trust based schemes impose similar duties on trustees. There may be a perceived barrier in relation to funds which have both financial and non-financial objectives.

B. Question 3

In relation to question 1 above, is the size of funds a major issue? If so, are there legal obstacles to scheme mergers?

## B.1 Scheme size

B.1.1 Aside from very small schemes (where certain regulatory requirements do not apply), we do not consider that scheme size of itself creates any material difference in fiduciary or regulatory barriers to investment in infrastructure, socially significant infrastructure or other forms of social investments.

B.1.2 However, in relation to the structural barriers listed in section A.6 above, we consider that larger schemes will tend to be better placed to overcome these barriers.

B.1.3 A large trust-based scheme with significant assets in its default fund may be better placed to tolerate some illiquidity in relation to a small proportion of its assets and still be able to maintain liquidity at an overall fund level sufficient to satisfy member transfer requests promptly. Similarly larger schemes are likely to have trustee boards capable of devoting greater time and expense overcoming inertial and governance issues which may be disproportionate for a smaller scheme.

B.1.4 The issues of increasing governance and regulatory obligations becoming disproportionate in small trust based DC schemes is well documented and there are legal processes permitting such schemes to be merged. However, in our experience it is more likely that an employer operating a small trust-based DC scheme for its employees will look at moving to a contract based arrangement or a master-trust in order to reduce governance. In practice we consider that such changes are unlikely to be driven by issues relating to investment in infrastructure, socially significant infrastructure or other forms of social investments.

## Appendix 2

Relevant learning objectives related to establishing “suitability” which are included in the Adviser Competency Training for social investment syllabus (from the Worthstone Social Investment Academy)

- Explain what motivates clients to invest in social investment projects
- Explain how to identify the client’s specific areas of interest in social goals and the similarities and differences between this and the conventional discovery process
- Explain the possible financial products to achieve social objectives and how to compare these
- Explain the approach to, and process of, asset segmentation within a client’s portfolio and describe how to establish and map client's return priorities on a spectrum of possibilities
- Explain how social return and financial return can be blended within a single investment offering.

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Bates Wells Braithwaite

**Law Commission Call for Evidence: Pension Funds and Social Investment**

**Response of Bates Wells & Braithwaite London LLP**

This is the response of Bates Wells & Braithwaite London LLP to the Call for Evidence: Pension Funds and Social Investment, issued on 7 November 2016. This response also incorporates the response of Comron Rowe, a leading pensions specialist who is a partner at Temple Bright LLP. We welcome consideration of this area by the Law Commission, given the increased growth in social investment and scope of opportunities within the pension funds investment market.

This response is made up of three papers, being:

**Paper A** addresses the barriers to pension funds investing in infrastructure, socially significant infrastructure and other forms of social investment, and examines the legal and regulatory causes of such barriers whilst proposing solutions.

This paper addresses questions 1, 2 and 3 of the Call for Evidence.

**Paper B** addresses the existing social investment opportunities in the market and the opportunities and barriers therein, and proposes solutions to the barriers identified.

This Paper addresses questions 1, 6, 7 and 9 of the Call for Evidence.

**Paper C** addresses the question of barriers to social investment caused by the existing legal framework in relation to social enterprises, and proposes solutions to these barriers.

This Paper addresses question 10 of the Call for Evidence.

**Contact**

**Bates Wells & Braithwaite London LLP**
**15 December 2016**

## Law Commission Call for Evidence: Pension Funds and Social Investment

## Paper A: Barriers to pension funds investing in certain types of investments

### Executive summary

Broadly, the biggest practical barriers to pension funds investing in infrastructure and socially significant infrastructure currently include:

- structural issues with the way in which pension funds invest, and are advised to invest, including concerns that such investments may not comply with duties to act in the best financial interests of beneficiaries; and
- practical issues around the scale and liquidity of infrastructure investment together with the challenges associated with direct infrastructure investments, such as identifying projects and due diligence.

The biggest practical barriers to other forms of social investment also include similar structural issues around pension fund investment and investment advice together with the perceived risks associated with social investments, which may often be in smaller higher risk projects, compared to the potential returns available from such social investment.

We propose providing high level strategic suggestions in our response rather than providing a detailed analysis of the relevant law and regulations, the differences between trust based and contract based DC pension funds or the differences between default funds and member selected funds. The extracts from the Fiduciary Duties of Investment Intermediaries (Law Commission Report No 350) contains a detailed and thorough analysis of the legal position.

In our view, the simplest practical solution in the context of DC pension funds is likely to be:

- to introduce a requirement for all DC pension funds to invest an appropriate percentage of their default fund in such investments by a particular future date; and
- to simultaneously facilitate the creation of pooled infrastructure funds, along similar lines to pooled commercial property funds, and make sure that these are appropriately regulated to protect pension funds from excessive risk exposures.

These steps are likely to encourage the development of a wider market for such investments. Where there is both supply and demand for such investments this will make it more likely that such investments will become a more readily accepted asset class.

However, care would need to be taken to make sure that any such market is appropriately regulated and does not expose pension funds and their beneficiaries to excessive risks, in particular, making sure that any pooled infrastructure funds carry out rigorous due diligence and ongoing monitoring of infrastructure investments on a transparent basis and that any concentration risk is mitigated.

### 1. DC default fund

In practice, a significant majority of DC pension fund members in both trust based and contract based DC pension funds are likely to be invested in the relevant default fund.

If the desired policy is to encourage investment in infrastructure, socially significant infrastructure and other forms of social investment, the simplest solution would be to introduce a legal requirement for all DC default funds to invest a certain percentage of their assets in such investments by an appropriate future date. This requirement could, for example, be incorporated into the automatic enrolment legislation and/or into the Occupational Pension Schemes (Investment) Regulations 2005. Such requirements could be introduced with a similar tapering and staging approach as used for the introduction of automatic enrolment so the largest DC pension funds bear the initial start up costs and risks associated with getting appropriate funds established.

We expect such a legal requirement would encourage the establishment of a more developed market in such investments over a period of time, which would become progressively more accessible to DC and DB pension funds.

Once a more developed market is established, it is more likely that such investments will be recommended by investment professionals (assuming such investment generate sufficient returns for an acceptable degree of risk) and also more likely that such investments will be made available directly as DC pension fund choices where pension fund members directly select particular investments.

We expect that members of pension schemes are likely to view any such investment requirements in a positive light provided that these investments generate appropriate investment returns over the long term. We expect this model will work best with socially significant infrastructure investments. Wider social investment may be less financially attractive to members if the risks are higher and rewards lower than infrastructure investment but many members may be prepared to accept this.

If there are concerns around imposing such a requirement on DC pension funds then it may be possible to allow members to voluntarily opt out of this default fund infrastructure and/or social investment requirement, in a similar way to the way in which members can opt out of automatic enrolment, perhaps even with a similar automatic re-investment process into such funds every three to five years.

## 2. Pension fund and trustee duties

Pension fund trustees are generally risk averse and bound by fiduciary duties to act in the best financial interests of the members. This includes balancing potential risks against potential returns and, unfortunately, the Scargill case has limited the appetite of pension fund trustees to consider social or ethical investments for many years. Similar concerns apply to contract based DC pension funds, in particular to the choice of default fund.

However, there has been a growing focus on Environmental, Social and Governance (ESG) factors in recent years, and an acknowledgement that ESG factors may have a positive impact on long term returns and risk exposures associated with particular investments.

Further, with trust based pension funds, the trustees of such funds are legally required to take proper advice on investment decisions or to delegate the investment decisions to an appropriate investment professional under a discretionary mandate.

The majority of investment professionals are likely to recommend more traditional asset classes and investments, which they are familiar with and do not require extensive due diligence, especially when advising smaller pension funds.

Therefore, unless:

- pension fund trustees are given comfort that infrastructure, socially significant infrastructure or other forms of social investments are in accordance with their legal duties, including the duty to act in the best financial interests of beneficiaries; and

- investment professionals start to recommend investment in such investments on a regular basis;

we expect that the level of such investment will remain limited.

As suggested above, the simplest way to address this issue is likely to be to introduce an express legal obligation to invest in such investment to override any trustee concerns or investment professional inertia.

3. **Pension fund investment**

In practice, the vast majority of pension funds (both DB and DC) will rely on investment professionals to assist with and guide investment decisions and the range of investment options available for DC pension funds where members are able to select their investments.

Given the potential for inertia amongst pension fund trustees and their investment professionals identified above, we expect significant structural changes will be required to incentivise such investments. The simplest solution we have identified would be to expressly require some or all types of pension fund to invest a certain portion of their assets in such investments by law.

Further, our understanding is that the more traditional investment markets currently tend to be short term transactional driven with a focus on very liquid investments. Fund managers and investment professionals may also be directly or indirectly remunerated on the basis of a regular churn in investments. We feel that the current position, where investment managers feel mandated to have daily mark-to-market often believing that that this is a legal requirement, is surplus to requirements. We believe that there should be clarity that diversifying portfolios and long-term stability are important factors, as well as liquidity. Infrastructure investments are generally long terms investments with limited liquidity and so do not necessarily fit well with the current structure of the investment market and this may also need to be tackled by structural changes.

4. **Structural changes required**

Our view is that we are likely to need significant structural changes in a range of areas to facilitate investment in infrastructure, socially significant infrastructure and other social investment.

We expect that these structural changes are likely to include some or all of the following:

- Changes in legislation to give DC and DB pension fund trustees and the governance committees for non-trust based DC pension funds comfort that

investing in such investments will not be in breach of their fiduciary duties to act in the best financial interests of pension fund beneficiaries. As stated above, the simplest way to address this is likely to be to introduce a legal requirement on DC pension funds to invest a certain percentage of default fund assets in such investments. This should expressly override any concerns around whether such investments are in the best financial interests of members. Alternatively, the necessary changes could potentially be introduced in a way which is analogous to the provisions in the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 which prescribe the appropriate ranges of assets and maximum asset allocations for the LGPS.

- Facilitating and incentivising the creation of pooled investment vehicles which allow a wider range of pension funds to invest in a spread of such investments to help manage the risks associated with direct investments and help improve liquidity. A purely market driven approach would be to create the demand for such pooled investment vehicles and allow the investment markets to develop appropriate products with limited regulatory intervention. However, in practice, a more closely regulated approach may be appropriate to make sure that any such vehicles meet the relevant policy objectives and do not expose pension funds and their beneficiaries to excessive risks.

- Reconsidering the transactional nature of current investment markets and incentives for investment professionals to encourage longer term investment more suited to infrastructure and social investment, rather than the short term churn of more liquid investments. As highlighted above, there may be issues around existing approaches to remuneration of investment professionals advising pension funds being linked to transactional investment strategies rather than long term investment which may need to be tackled, in a similar way to the way in which commission based remuneration for financial advice has been tackled recently by the Retail Distribution Review and replaced with more transparent fee based remuneration.

- Incentivising the establishment of larger pension funds such as master-trusts and/or facilitating the merger of existing DC and DB pension funds to facilitate more direct investment in infrastructure and socially significant infrastructure. However, in practice, we expect that employers operating smaller trust based DC pension funds are more likely to close such funds following the introduction of the new DC governance requirements and shift to master-trusts or contract based DC pension funds rather than taking the merger approach.

## 5. Direct investment by pension funds

In our view, the size of funds is a major issue where pension funds are investing directly in infrastructure and socially significant infrastructure. The size of funds may also be an issue where investing in other forms of social investment, depending of the scale and risk profile of such investments. Many social enterprises are seeking relatively small, discrete investments, which may not be efficient and practicable from the point of view of an investment manager.

Our understanding is that it is currently only the largest UK pension funds (and predominantly DB pension funds) which are investing in infrastructure. Our understanding is that the majority of these funds are investing directly in specific infrastructure projects and

that, broadly, such investments are yielding good long term returns so their experience of doing so is a positive one.

This follows the infrastructure investment model seen internationally where very large pension funds in various other countries such as the Ontario Teachers' Pension Plan (which has, for example, invested directly in Birmingham and Bristol airports and HS1 in the UK) and CalPERS (the biggest US public pension fund which, for example, aims to invest 1% of its assets or approximately $3bn in infrastructure and has recently invested in toll roads in the US) have invested directly in large infrastructure projects.

Direct investment in infrastructure comes with various significant challenges including identifying viable projects, doing due diligence and risk assessments on such projects, structuring appropriate investment into such projects and the ongoing scrutiny of the performance of such projects together with issues of scale and liquidity. Generally, this means that it is only the very largest pension funds that are likely to have the scale and resources to manage such challenges effectively.

Further, pension funds are under a duty to spread their investment risks and need to maintain an appropriate degree of liquidity and these factors also restrict the direct investment approach to the largest pension funds, which are able to invest significant sums for long periods of time without allocating more than a few percent of their assets to such investments or adversely affecting their overall liquidity.

## 6. Development of pooled investment vehicles

However, in practice, if a market were to develop where such infrastructure, social infrastructure and other social investments were to be pooled either with other similar investments or, alternatively, with a range of more traditional investments, this should mean that pension funds would be able to invest smaller sums on a more liquid and lower risk basis.

This could, for example, be analogous to investing in a commercial property fund which may invest in a number of large illiquid assets and the income streams from them but allow investors to invest smaller sums and have a greater degree of liquidity than the underlying asset class.

This kind of pooled investment vehicle would help to address many of the issues which currently block pension fund investment in infrastructure. If such a market were to develop and be readily available and recommended by investment professionals as an established asset class then we expect that the size of funds would no longer be a material issue.

However, the issues around identifying viable projects, doing due diligence and risk assessments on such projects, structuring appropriate investment into such projects and the ongoing scrutiny of the performance of such projects together with issues of scale and liquidity would need to be dealt with by the relevant pooled investment vehicle. Any pension funds investing in any such pooled investment vehicle would need to have confidence that such issues have been appropriately addressed.

Therefore, a new and specific regulatory structure for such pooled investment vehicles might be required to ensure that any such pooled investment vehicles do not put pension

funds at risk in the same way as, for example, pension fund investment in bundled sub-prime mortgages.

The development of pooled investment vehicles may also be appropriate in the context of other social investment, for example, a social investment fund which spreads risk across multiple smaller and higher risk social investment projects. We feel that there is the potential for "wrappers" and funds to be created containing a diversified portfolio of social investments. This would allow social enterprises access to the funds they require, without the pension fund itself having to directly acquire all of the investments in question. It is our view that government should engage with stakeholders in relation to the development of such options. Imposing the requirements we suggest above on investment managers could also work towards incentivising investment managers to create, develop and offer a wider range of suitable social investment products for pension funds.

## 7. Legal obstacles to scheme mergers

Smaller trust based DC pension funds are operated by particular employers and, in practice, are unlikely to merge with other smaller trust based DC pension funds.

We expect such pension funds are more likely to be closed by employers and replaced with alternative pension funds as the new DC governance requirements place additional regulatory burdens on such pension funds.

We suggest the legislative focus is on ensuring that DC master trusts (which have multiple participating employers) and contract based pension funds are appropriately governed and regulated and are able to develop the appropriate scale to facilitate such investment.

Further, we suggest making sure that the rules which apply to such pension funds do not unreasonably obstruct investment in infrastructure, socially significant infrastructure or other social investments.

As stated above, if the policy is to encourage and facilitate pension funds to invest in such investments then it may well be appropriate to take this one step further and actively require such pension funds to invest a certain percentage of their default fund or wider assets in such investments to facilitate the development of appropriate investment vehicles at the same time as establishing an appropriate regulatory structure for such investment vehicles to ensure pension funds are not exposed to unacceptable levels of risk.

**Law Commission Call for Evidence: Pension Funds and Social Investment**

**Paper B: Existing and potential opportunities in the social investment market**

## Executive summary

This note examines how the existing market for social investment could be utilised by pension funds to increase the amount of funds which are socially invested. We believe that the changes we propose would better enable pension funds to invest socially, creating benefits for local communities and society generally, whilst adequately growing and protecting investors' pensions.

In summary:

- The social investment market is flourishing, with a wide range of opportunities which could be effectively utilised by pension funds.
- However, there remain barriers in relation to both social investing generally and social investment in pensions.
- As we explain above, the majority of individuals in defined contribution pension schemes invest in the scheme's default fund – as such, we recommend that there should be a legal requirement that all pension schemes' default funds comprise a certain agreed percentage of social investments, which is determined on the basis of the perceived absorptive capacity of the social investment universe, with the remainder responsibly invested.
- These requirements will incentivise investment managers to offer a range of socially invested pension options, including a variety of funds and wrappers, which will decrease liquidity risks and scalability issues. There are already examples of very large microfinance funds.
- Social investments should be defined broadly for this purpose and could include allocations to charities and asset locked social enterprises, as well as allocations for example to mission-led businesses and local government and infrastructure projects.
- Investment managers and financial advisers should be obligated to perform "know your client" exercises on all of their clients to find out not only the financial needs of their client, but also the types of negative impacts clients would like to avoid and the positive impacts clients would like to see from their investments.

## 1. The existing market and potential opportunities for pension funds

We have recently seen large growth in the area of social investment, with many of our charitable and social enterprise clients seeking to raise capital in a variety of ways. There have also been various recent developments in relation to social investment, including a new social investment power for charities[1], and social investment tax relief[2]. This growth can be attributed to a range of factors, including a decrease in government grants available, and new technology making it easier for social enterprises to seek and utilise social investments. It can be difficult for social enterprises to raise finances from banks in the traditional manner, due to high interest rates and the requirement of banks that the social enterprise in question has good security. To give just some examples of the types of social investment opportunities we are seeing in the market, these can range from communities investing in local renewable energy projects or raising finance for specific community projects, to large charities and social enterprises issuing shares (in the case of social enterprises) and bonds (in the case of charities).

## 2. Barriers to social investment by pension funds, and proposed solutions

[1] Introduced by Section 15 of the Charities (Protection and Social Investment) Act 2016: http://www.legislation.gov.uk/ukpga/2016/4/contents/enacted

[2] Introduced by Section 57 of the Finance Act 2014: http://www.legislation.gov.uk/ukpga/2014/26/contents/enacted

Whilst we feel that there are many varied opportunities for pension funds to invest socially, we have also identified a range of obstacles which could create barriers to pension funds investing in this way.

2.1 *Definition of social investment*

There remains a fundamental question around the definition of a social investment. There is a large spectrum of investing which could be deemed "social", ranging from social investment in the narrow sense such as community members investing in a renewable energy project in their community, and investment in charities, to other types of investment with broad social impact, such as investment in infrastructure.

In our view, for the pensions market to take advantage of the social investment opportunities available, it is necessary to take a wide view of what social investment is. It is important that the range of opportunities in the social investment market is fully recognised. This could include investment in "mission-led" profit organisations, and other business which aim to make a positive impact on the community and environment. The B Corp movement is an example mission-led business – B Corps are a certification issued to for-profit companies by B Lab, a non-profit organisation, which certifies business as B Corps on the basis of rigorous standards of social and environmental performance[3]. These are organisations which do not have an asset lock or restrictions on profit distribution and so are inherently scalable. Other potential areas for investment include social housing and other infrastructure projects. These are areas where we feel that there is scope for more creativity in relation to investment, and investments where we feel pension funds could generate returns in a scalable manner. As such, any definition of a social investment should be sufficiently wide or flexible to cover a range of different investments.

A potential way to maximise the opportunities available to pension funds, and to sufficiently diversify the pension fund's portfolio, would be to create a system where 10% of the default fund must be invested socially, with 5% to include more "traditional" social investments (including in charities, community interest companies and community benefit societies, using similar criteria to that used to decide which organisations are eligible for Social Investment Tax Relief). The other 5% could be invested more widely in larger organisations which have some element of mission-led purpose or are involved in sectors which involve the creation of goods or services which are clearly socially valuable, such as infrastructure and social housing.

2.2 *How investment mandates are set*

We explain above that there are often trustee concerns around social investment, and we think that an express legal obligation to invest in such investment would override trustee concerns or investment professional inertia. In our view, a further significant barrier to social investment by pension funds is the way in which the mandate given to pension trustees and their appointed investment managers is framed. Unless a financial adviser, pension provider or investment adviser at the start of the client relationship has to find out the individual's impact goals and aims, the default course of action will be for them to invest in the fund producing the highest risk-adjusted financial return – this is how the system currently operates, and what is encouraged. Advisers are not currently incentivised to look at social options, and may not even be aware of the options available. However, we feel that

[3] https://www.bcorporation.net/what-are-b-corps

awareness of such options should be part of the continuing professional development requirements of financial advisers and investment managers, and a requirement of the "know your client" process.

In addition, a regime should be created to require pension funds to consult scheme members about the different positive and negative impacts investments have with a view to this consultation process informing the responsible investment policies and approaches of pension funds. Any such regime should be framed in such a way as to ensure that trustees are able to have confidence that by following the views of members during the consultation process, trustees are acting lawfully and will be beyond challenge on the part of dissenting scheme members. This would have the effect of empowering scheme members and ensuring that investments better reflect the interests and wishes of scheme members, as well as reducing the risk of unsuitable investments.

We have previously highlighted, in our response to the FCA's Call for Input in relation to Regulatory Barriers to Social Investment[4], that there is an incomplete understanding in relation to "suitability" of investments. Whilst investment managers do have to select assets which are suitable, this should not mean suitable from a financial perspective only.

Our view is that many individuals would be very surprised to discover what their pension is actually invested in, and that financial advisers and investment managers should have a "know-your-client" responsibility to find out their client's impact goals when investing, including in relation to ethical investment and social impact. There should also be greater transparency when consulting with individuals in relation to the discrepancy between what they are actually invested in and what they would like to be invested in.

If mandates better reflected pension savers' impact goals and wishes, this would incentivise and encourage investment managers to be creative in relation to discovering and making available social investment options – we expand on this further below.

**Conclusions**

In summary, there are definite opportunities in the market for pension schemes to invest socially – social investment opportunities are increasing, and such opportunities can have dual benefits of improving local communities and society more generally, and diversifying and therefore strengthening the long-term viability of pension funds - after all, many charities have operated consistently for many years. The recent report of the Expert Group of the European Commission on Social Entrepreneurship[5] highlights this, stating that social enterprises and larger social economy contribute to achieving smart, sustainable and inclusive growth, and calls upon member states to direct public funding to mobilise private capital through investment in and de-risking of social enterprise funders.

As such, we feel that socially invested pensions should be rolled out further in the UK, and that a requirement upon all pension schemes to have a certain percentage of assets invested in social investments would be a positive step forward. In our view, this could be similar to the system in France, where each pension provider has to offer a "Solidarity Investment Fund", where 90% of the assets are invested in typical investments, with up to 10% of the fund invested in social investments. We would in fact go further and argue that there should be a requirement that all default funds should contain at least an agreed

[4] http://www.bwbllp.com/file/fca-call-for-input-submission-of-bates-wells-and-braithwaite-london-llp-14-3-16-pdf
[5] http://ec.europa.eu/DocsRoom/documents/19941/

percentage of social investments, which is determined on the basis of the perceived absorptive capacity of the social investment universe, with the remainder responsibly invested

As flagged above, to optimise the opportunities available, a wide definition of “social” should be taken, which comprises of more traditional charitable and social enterprise organisations, but extends to for-profit, mission-led businesses, potentially with a percentage allocation to asset locked organisations and a percentage allocation to the wider social or impact investment universe – this would allow pension schemes to invest in a diverse range of social investments. Investment managers and financial advisers should be obligated to perform “know your client” exercises on all of their clients to find out not only the financial needs of their client, but also the types of negative impacts clients would like to avoid and the positive impacts clients would like to see from their investments

## Law Commission Call for Evidence: Pension Funds and Social Investment

## Paper C: Barriers created by the existing legal framework around social enterprises

### Executive summary

There are many legal forms which social enterprises can take at present, and although some argue that there are too many different legal forms, we believe that the different forms available suit different circumstances. However, in our view, the landscape of regulation is fractured, creating barriers to social investment. We think that three of the main obstacles within the existing legal framework around social enterprises, creating barriers to social investment, include: a) an inconsistent approach to regulation of social enterprises; b) the complex rules around financial promotions; and c) the asset lock imposed on certain types of social enterprises by regulation.

We believe that a more consistent and cohesive approach to regulation would encourage and facilitate social investment, thereby creating more opportunities in the market for pension funds to invest into. We believe that a single regulator, the "Social Economy Commission", could remove barriers to investment. We also believe that the complex rules around financial promotions should be clarified and applied consistently to different social enterprises. Whilst we think that the asset lock on certain types of organisations is justified, we do not think that this should be extended or increased.

### 1. Overview of the legal framework around social enterprises

There are a range of legal forms which a social enterprise can take in the UK. These include: community interest companies ("**CICs**"), regulated by the CIC Regulator; charitable companies limited by guarantee or taking some other legal form, regulated by the Charity Commission; community benefit societies and cooperatives, both regulated by the FCA; and companies either limited by guarantee or by shares, which are registered with Companies House only.

### 2. Barriers created by existing legal framework

2.1 *An inconsistent regulatory approach*

Community benefit societies and cooperatives are registered by the Mutuals Team at the FCA, for historic reasons – the FCA inherited the role from the Registrar of Friendly Societies. The FCA has said that it does not regulate these types of organisation in its role as Registrar, but merely "registers" them, and has the power to remove them from the register. Now that community benefit societies and cooperatives are undertaking activities not traditionally undertaken by these types of entity, including seeking social investment and reaching out to investors in new ways, the FCA does not seem to be well disposed towards innovation by these forms and does not seem to take a very joined up approach with regulators of comparable forms, such as the Charity Commission or CIC Regulator. We highlight the issues in relation to financial promotions by these types of organisation below. We also explain in further detail the issues around regulation of these types of organisation in our previous response to the FCA (see footnote 1). We also note here that the FCA seems to have recently adopted a more interventionist approach to cooperatives and community benefit societies, one which we consider to be subject to challenge and which seems to be driven primarily, if not openly acknowledged, by investor protection concerns, rather than the proper concerns of a registrar.

In relation to CICs and charities, the CIC Regulator does take a less interventionist approach when compared to the Charity Commission or the FCA. With the advent of social investment tax relief, these differences in regulatory approaches run the risk of regulatory arbitrage between the different legal forms and so there is a greater need now for cohesion and co-ordination in the regulatory environment than ever before.

We feel that it would be beneficial for there to be a single Social Economy Commission which has responsibility for social enterprises generally. The powers of the FCA in relation to cooperatives and community benefit societies should be transferred to a beefed-up CIC Regulator, which could in turn form this new Social Economy Commission. This Commission would become a source of expertise and knowledge, helping to create not only a more mature regulatory environment and greater visibility and recognition for social enterprise but also leading to better informed policy within Government on all matters concerning social enterprise and social investment. The Commission could be responsible for accrediting social impact bonds and even community investment tax relief. It would become a single centre of knowledge, informing policy and encouraging cohesion.

It is our view that the Charity Commission should remain separately responsible for the regulation of charities, which have a long and distinguished history and a very different system of regulation and tax treatment. The Charity Commission could continue to regulate the charitable aspects of organisations which are registered charities, and work with this new Social Economy Commission on matters of joint interest, such as investment by charities into social enterprises.

2.2 *Rules around financial promotions*

We do not propose to set out detailed thoughts on the rules around financial promotions here, as we have previously summarised our views comprehensively in our response to the FCA in relation to social investment (see footnote 1).

In summary, in our view, the rules around financial promotions by social enterprises are complex, confusing and inconsistent. In short, local communities do not have the capacity to deal with regulation around financial promotions – full compliance with the FCA's Conduct of Business rules and other relevant rules could cost an organisation several thousand pounds when obtaining advice. Co-operatives and community benefit societies enjoy exemptions from these rules which facilitate community level social investment activity. There is no logical reason why charities and community interest companies should not be treated similarly to co-operatives or community benefit societies. However, our view is that, instead of unregulated social investments and fully regulated social investments, there is a need for an intermediate approach for community level social investment with minimum standards that apply to charities, CICs, co-operatives and community benefit societies.

This confused landscape is an indirect barrier to socially invested pensions, as the opportunities for social investment generally and the profile and availability of retail social investments are more limited, due to inconsistent patchwork of rules we currently have and the way this restricts and inhibits many social enterprises from raising investment.

2.3 *Asset lock*

Statutory asset locks exist for CICs and certain community benefit societies. This means that organisations subject to the asset lock cannot transfer assets for less than market

value, and dividends to private investors are restricted. This can be a concern to investors, as this can make it more difficult for them to generate returns.

We feel that the existing rules around asset locks are justified at present, for the purpose of protecting the social mission of the organisations in question. We are not aware of reasons why the rules applicable to these asset locks should change.

## 3. Conclusion

To better facilitate social investment in social enterprises, a coherent and well designed regulatory system is needed that applies across the major forms of social enterprise. We believe that this would be best facilitated by a single regulator for the key forms of social enterprise, which would work closely with the Charity Commission in formulating and implementing sustainable, helpful and clear guidance on social investing. We also believe that there is a need to review the financial promotion rules so that the rules apply consistently across all major forms of social enterprise in a logical way which is designed to protect investors and to enable community level social investment.

**THE LAW COMMISSION**

**PENSION FUNDS AND SOCIAL INVESTMENT**

This optional response form is provided for consultees' convenience in responding to our call for evidence on pension funds and social investment.

The response form includes the text of the questions in the call for evidence, with boxes for yes / no answers (please delete as appropriate) and space for comments. You do not have to respond to every question. Comments are not limited in length (the box will expand, if necessary, as you type).

Each question gives a reference in brackets to the paragraph of the call for evidence at which the question is asked. Please consider the surrounding discussion before responding.

We invite responses from 7 November 2016 until **15 December 2016**.

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By post to: Lucinda Cunningham, Commercial and Common Law Team,
Law Commission, 1st Floor Tower,
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| Any information you give to us will be subject to the Freedom of Information Act 2000, which means that we must normally disclose it to those who ask for it.<br>If you wish your information to be confidential, please tell us why you regard the information as confidential. On a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not be regarded as binding on the Law Commission.<br>***The Law Commission processes personal data in accordance with the Data Protection Act 1998 and in most circumstances it will not be disclosed to third parties.*** |

## YOUR DETAILS

| | |
|---|---|
| Name: | |
| Organisation: | Chancery Bar Association |
| Role: | |
| Postal address: | |
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| Yes: | No: ✓ |
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**QUESTION 1: BARRIERS TO PENSION FUND INVESTMENT**

(Call for evidence, paragraph 1.15)

What are the barriers to pension funds investing:

(a) In infrastructure generally?

(b) In socially significant infrastructure?

(c) In other forms of social investments?

The following are potential barriers to default pension funds investing in infrastructure, social infrastructure and/or social investments (as specified where separate):

1. Pension trustee's powers of investment are particularly wide (s34 Pensions Act 1995). However, it is subject to "any restrictions imposed by the scheme", such that it is possible that investment powers may be restricted by the pension scheme documentation such as to rule out or have the effect of ruling out investments in infrastructure/social investments;

2. Moreover, although the power in s34 is expressed to be akin to beneficial ownership, it does not mean that it is open to trustees/fund managers to take a degree of risk which a person may do with his or her own investments. The investment duties of trustees/fund managers, including particularly the fiduciary, common law care and skill and specific statutory investment duties applicable to pension trustee when concerned with positive decisions to be made in respect of default funds where the specific consent of the beneficiaries to the investment in a particular fund/asset is not forthcoming, may not fit particularly easily with the present offerings for infrastructure/social investments on the market.

3. One particular point here is that, in considering whether a trustee has complied with her/her duty, a Court will apply the standard of an ordinary prudent man of business, which standard will be higher in the case of a professional. The duty includes an obligation to avoid excess levels of risk. In considering these questions a Court will have regard to contemporary investment practice. It is perhaps a case of 'chicken and egg', but until social investments become more attractive and 'mainstream', a cautious trustee may consider more traditional investments simply safer and hassle free (and less costly, since a particularly risk adverse trustee may, in the context of the

social investment, feel the need to seek not only financial, but also legal advice on the powers and duties of investment in this field). Similarly, while private equity or sovereign wealth funds may be more willing to invest in risker and more uncertain infrastructure type projects, pension trustees/fund managers will on the whole likely take a far more cautious approach to investing default funds.

4. In particular, Paras 4 & 4A of the Investment Regulations (SI 2005/3378) ("the 2005 Investment Regs") require that, regardless of the size of the scheme, assets in a default arrangement must be invested in the best interests of members, and where the scheme has more than 100 members, the power of investment must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole, and fund assets must be invested in a manner appropriate to the nature and duration of the benefits payable under the scheme. In so far as there is reluctance among pension trustees/investment managers to invest default funds in infrastructure/social investments, it is likely because they do not, or it is not obvious or clear, that they meet or are likely to meet these criteria. Questions of liquidity and the manner of investment are obviously important, particularly with the need to invest for particular members in low risk, easily accessible assets, which in the absence of a ready market to buy and less social investments will create a difficulty for schemes. Equally, while a riskier investment profile may be suitable for younger members, it will need to be a profitable investment, and there may be some difficulty with investments where the return is uncertain, speculative or low, or is perceived to be such, compared to traditional type investments. There may also be a perception that social investments are more high risk and thus less secure in terms of return, and demands of a higher yield to compensate for that risk may create impediments in the marketplace. In the absence perhaps of some form of government backing or guarantee behind a social investment, this may create a particularly high hurdle to overcome.

5. More particularly, paras 4(5) & (6) of the 2005 Investments Regs specifically require that assets of the scheme with 100 or more members 'must' consist predominantly of investments admitted to trading on regulated markets, and assets which are not so invested must be kept to a prudent level. In so far as an infrastructure/social investment opportunity is otherwise on a regulated market, it may prove particularly difficult for funds, save for the largest funds, to be invested or invested to a significant extent therein.

6. A similar issue arises from the requirement in Para 4(7) of the 2005 Investment Regs to all schemes to diversify, particularly for all but the largest

funds.

7. Further, by s35 Pensions Act 1995 and paras 2 & 2A of the 2005 Investment Regs trustees of schemes with 100 or more members are to produce a statement of investment principles, explaining the aims and objectives in respect of investments and policies and how they are intended to ensure the assets are invested in the best interests of the group of the members investing in a default arrangement. It may prove difficult to explain why a social investment, which may not produce as high a return as a more traditional investment, or a risky infrastructure project (which have a propensity to overrun and exceed budgets) are in their best interests. But even if this can be overcome, it may prove to be administratively unworkable to determine or attempt to divine what type or types of infrastructure / social investments are for the best interests of the relevant group, particularly if they are large and diverse. Aligned with this is the issue as to the definition or determination of 'social' investments: one member's 'social' investment may not chime with another member's viewpoint; similarly, reasonable people can and do take very different views on infrastructure (e.g. HS2, Heathrow's Third Runway, nuclear vs green energy, etc). Moreover, the particular explanation will also likely need to be rather larger than with traditional investment strategies, covering the justification for investing in particular social issues perhaps to the exclusion of others, which again may put trustees off considering them for investments.

8. By Para 2A of the 2005 Investment Regs, there is also an obligation on larger schemes to regularly review and revise the investment strategy, including by reference to the return on investments. There is also an obligation on trustees to regularly value their funds and investments and also provide information to members of the value of their pension. One issue with infrastructure and/or social investments may be one of valuation (both the administrative workability and expense of obtaining the valuation, and the question of how a social investment might actually be valued) of the investment asset in question, or at least a regular valuation, compared with more traditional investments on the regulated market.

9. For the purposes of producing a statement of investment principles, trustees must obtain and consider appropriate advice. Moreover, trustees have the power to delegate actual decisions as to investments (and usually do so). To this end, there may be an issue whether there exists in the marketplace suitably qualified advisors/investment managers who have the necessary expertise to make appropriate investments in infrastructure/social investments, alongside more traditional investments or otherwise, and/or of a

| sufficiently diverse nature to meet the trustee's duties. In particular, it may be that in order to meet the requirement of diversification, a number of investment managers will need to be employed for these purposes, adding significantly to the costs of administering the fund.<br><br>10. Overall, we are of the view that the barriers to investment are not so much the relevant powers/duties imposed on trustees/fund managers in respect particularly of default arrangements. They have developed sensibly over the years to produce a prudent and acceptable level of protection for members. In so far as there is a resistance to investing in infrastructure / social investments, it may perhaps be due to the present offerings not, from the perspective of a default fund, being sufficiently well known, diverse, attractive, in a readily investable form and/or at an acceptable level of risk. In other words, the barrier to such investments may not in truth be the law itself, but rather the investments as a package themselves, such that it is not necessarily the law governing investments which may need to adapt, but the investment offerings. |
|---|

**QUESTION 2: LEGAL AND REGULATORY BARRIERS**

(Call for evidence, paragraph 1.15)

Do any of those barriers (identified in Question 1) relate to issues of law and regulation?

| Yes: | | |
|---|---|---|
| In 1-9 (as detailed therein), save for the observations in 10. | | |

**QUESTION 3: SIZE OF PENSION FUNDS**

(Call for evidence, paragraph 1.15)

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

| Yes: | | |
|---|---|---|

Larger funds (your Scottish Widows and Avivas), which have deeper pockets, access to quality advice and investment management and can offer a wider and more diverse range of investments, are less likely to be hamstrung by the matters set out in answer to Q1 above when considering, for the purposes of default arrangements, investing in infrastructure / social investments.

The issues arise more in relation to smaller funds and master trusts, and it is understood that there is a move to increase their size, including by merger.

The legal route to a merger is essentially by the bulk transfer of assets and liabilities from one scheme (usually the smaller one) to another (usually the larger one), or by both schemes transferring to a newly established scheme. It is often (but not always) accompanied by the winding up of the transferor(s).

There are not so much legal 'obstacles' to such mergers, but rather a legal 'process' to follow and practical/commercial issues to consider.

The first part of the process is to determine whether there is sufficient power within the terms of the scheme documentation to allow a bulk transfer.

If so, conditions for its effective exercise are usually stipulated, such as obtaining employers/members' consent. There may also be employment related issues to consider, including whether any particular assurances have been made to employee members.

Where member's consent is not forthcoming, an occupation pension scheme may permit a bulk transfer where the conditions of paragraph 12 of the Occupational Pension Schemes (Preservations of Benefits) Regulations 1991/167 are first satisfied. In essence, for stakeholder money purchase schemes under trust this means the transferring scheme (another occupational scheme or a personal pension) has commenced winding-up and the transfer payment is of an amount at least equal to the cash equivalent of the member's rights under the scheme as calculated and verified in prescribed circumstances. Otherwise, the transfer will need to be to another occupational pension scheme where there will need to be a

employment connection between the schemes and the transferring member will acquire transfer credits broadly no less favourable than the rights being transferred.

Subject to that, as with Q1, trustees when exercising their power are subject to fiduciary duties to act within and for the purposes of their power, in the best interests of the members and taking into account all relevant factors and ignoring irrelevant factors.

For those purposes, the commercial terms of the transfer will be all important.

Overall, however, from our perspective it is not known what of these hurdles actually creates practical impediments to mergers.

**QUESTION 4: ETHICAL PENSION OPTIONS**

(Call for evidence, paragraph 1.18)

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?

n/a

## QUESTION 5: PENSION SAVER ENGAGEMENT

(Call for evidence, paragraph 1.18)

We seek views about how far these options (identified in Question 4) 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?

| Yes: | No: | Other: |
|---|---|---|
| n/a | | |

## QUESTION 6: RETURNS FOR SOCIAL INVESTMENT

(Call for evidence, paragraph 1.18)

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?

| Yes: | No: | Other: |
|---|---|---|

| n/a |
|---|

**QUESTION 7: FINANCIAL ADVISORS AND SUITABILITY**

(Call for evidence, paragraph 1.22)

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?

| n/a |
|---|

**QUESTION 8: LABELLING SOCIAL INVESTMENT OPTIONS**

(Call for evidence, paragraph 1.23)

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?

| Yes: | No: | Other: |
|---|---|---|

n/a

**QUESTION 10: LAW OF SOCIAL ENTERPRISES**

(Call for evidence, paragraph 1.25)

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?

| Yes: | No: | Other: |
| --- | --- | --- |

n/a

**FURTHER COMMENTS:**

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.

It is observed generally that many, if not all, of the questions posed here appear really to be practical ones aimed at pension providers/trustees/managers and advisors. In other words, it is considered that the issues raised by this call for evidence are not really for us. We can only give an overview of the legal framework/background against which issues of infrastructure / social investment arise (which we have sought to do, but appreciate is largely replicating the work of

the Law Commission in this field already). What is perhaps more pertinent is to discover why, from the investor's and investee's perspective, pension funds are not investing in infrastructure / social investments, and specifically what it is within the legal and regulatory framework that pension providers/trustees/managers and advisors consider in their experience are actual/potential impediments to investment.

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# COLUMBIA THREADNEEDLE INVESTMENTS

## SUBMISSION TO THE LAW COMMISSION CONSULTATION ON PENSION FUNDS AND SOCIAL INVESTMENT

## 15 DECEMBER 2016

**This optional response form is provided for consultees' convenience in responding to our call for evidence on pension funds and social investment.**

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**Each question gives a reference in brackets to the paragraph of the call for evidence at which the question is asked. Please consider the surrounding discussion before responding.**

**We invite responses from 7 November 2016 until 15 December 2016.**

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By email to: commercialandcommon@lawcommission.gsi.gov.uk.
By post to: Lucinda Cunningham
Commercial and Common Law Team
Law Commission, 1st Floor Tower
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London SW1H 9AG

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## CONFIDENTIALITY

**Do you wish to keep this response confidential?**
No

**Question 1: BARRIERS TO PENSION FUND INVESTMENT**

**(Call for evidence, paragraph 1.15)**

**What are the barriers to pension funds investing:**

**a) In infrastructure generally?**

There are both perceived and actual barriers to pension funds investing in infrastructure which relate in some extent to the nature of the asset class. Infrastructure investments are generally illiquid; they require greater resource and expertise in terms of investment governance; and they typically require a large investment commitment. It is for these reasons that small pension schemes in the main are not able to invest in infrastructure.

A lack of knowledge and understanding of infrastructure as an asset class also proves to be a barrier. The risk-reward characteristics of infrastructure investments are often not adequately understood and neither are the different options and implications of accessing the asset class through debt or equity.

**b) In socially significant infrastructure?**

The barriers to investing in socially significant infrastructure are the same as those for general infrastructure. However, in addition, there is a misconception that investing for a social good in some way inhibits the ability to also achieve a financial return for investors, which results in pension fund trustees shying away from investing in "socially significant" infrastructure opportunities. This is due in part to the lack of understanding and knowledge highlighted above, combined with trustees' desire to carry out their fiduciary duties which require them to "act in good faith when entering into transactions and invest prudently" on behalf of scheme beneficiaries. In reality, social investment need not mean a choice between achieving a social benefit and achieving a competitive financial return. This is a message that needs to be made clearer if social investment is to become more attractive to both retail and institutional investors.

A further impediment has been created by the raft of regulatory change and pension reform that has occurred in recent years, which has occupied the focus and resource of trustees - including the delivery of auto-enrolment, the introduction of the DC charge cap, the introduction of greater choice with regard to annuities, and the new DC Code of Practice. As a result, many trustees do not have the capacity to investigate social investment opportunities. They therefore attempt to meet their members' ESG objectives through the relatively rudimentary approach of excluding certain stocks from funds rather than embedding social objectives into the investment strategy.

**c) In other forms of social investments?**

There is a wide range of asset classes and securities that can be considered as other forms of social investment, from ethical equity funds, to charity bonds, to corporate bonds issued by socially beneficial organisations such as universities and housing associations. The majority of these have no additional specific barriers to investment, and unlike infrastructure many are not illiquid. With greater visibility, knowledge and understanding there is significant potential for DC pension schemes to access these investments and achieve a social focus within their mainstream investment strategies.

## QUESTION 2: LEGAL AND REGULATORY BARRIERS

**(Call for evidence, paragraph 1.15)**

**Do any of those barriers (identified in Question 1) relate to issues of law and regulation?**

No. There is nothing in the law that specifically prevents DB or DC pension scheme funds from investing in appropriate forms of social investment. However, for DC pension schemes in particular, the 0.75% member-borne charge cap makes such investments potentially difficult to achieve. With the prospect of a further reduction to the cap following the proposed review next year, we have seen many instances across the industry whereby trustees are seeking to future-proof their schemes by implementing low charges. An unintended consequence of this is the stifling of investment innovation and an inability to consider anything other than the most basic low cost investment options. The growth of passive investment among DC pension schemes is indicative of this issue. Industry figures reveal that 62%[1] of all pension schemes were actively managed in 2015, down from 66%[2] in 2009.

[1] The Investment Association Annual Survey, Asset Management in the UK 2015 – 2016

[2] Pensions Insight, 6 Sept 2013

## QUESTION 3: SIZE OF PENSION FUNDS

**(Call for evidence, paragraph 1.15)**

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

Scale is incredibly important for pension schemes. Members of larger pension schemes benefit from economies of scale and pay administration fees of as a little as 0.1%. In fact, in some scenarios, scheme trustees pay the administration fee which results in a greater investment budget. In contrast, members of smaller schemes pay administration fees upwards of 0.4%.

The member-borne DC pension charge cap of 0.75% limits the ability of small schemes to invest in the full spectrum of asset classes. For smaller schemes, the cap means a higher percentage of member-borne charges needs to be allocated to cover administration fees, so that there is significantly less left for investment charges. As a result, DC members are provided with different investment solutions depending, to some extent, on the size of their scheme.

Although the roll-out of automatic enrolment has boosted the number of people saving into a DC pension, the market is incredibly fragmented with large numbers of people automatically enrolled into one of hundreds of master trust schemes in existence. This has reduced scalability and has resulted in higher administration expenses.

One of the aims of the 2016 Pension Schemes Bill is to enhance master trust regulation by introducing more stringent capitalisation and governance requirements, which should lead to consolidation in this market. This would provide master trusts with scale and greater investment budgets, enabling them to move away from the predominantly low cost, passive investment strategies they currently employ and look to differentiate their offering for members.

The impact of scale is clear from the experience of Australian and Canadian pension funds. In Australia for example, large industry superannuation funds have made a point of investing in Australian infrastructure. According to Industry Super Australia, industry super funds have around £12 billion directly invested in Australian airports, railway stations, electricity generators, gas pipelines, water treatment plants, roads, shopping centres, schools, aged care facilities, hospitals and courts.

## QUESTION 4: ETHICAL PENSION OPTIONS

**(Call for evidence, paragraph 1.18)**

**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?**

There are close to 100 ethical DC pension funds available in the UK. NEST, the qualifying pension scheme set up as part of the government's workplace pension reforms, offers members the opportunity to invest in its ethical fund. Not all schemes however give members this choice.

**b) What proportion of people take them up?**

In our view, current member take-up figures will not provide a true reflection of investor appetite for social investment. Firstly, not all schemes offer an ethical fund. And while participation in the DC pension market has grown, scheme members remain reluctant to make investment decisions and as a result approximately 90%[3] of members contribute to the default strategy. Where socially responsible investments are available, they are more likely to be offered on a self-select basis.

**c) What sort of returns do they provide?**

A research report produced by Moneyfacts Group and published in August 2013 by Investment Life & Pensions Moneyfacts[4] (Issue 202) provides an overview of the ethical fund market including an analysis of fund performance across the sector over 1, 3, 5 and 10 years. The report demonstrates that there is certainly good evidence to show that some ethical funds can deliver on ethical principles without sacrificing returns.

[3] The Pensions and Lifetime Savings Association, Annual Survey for 2015 as reported by Employee Benefits, 10 October 2016

[4] Moneyfacts Group, Life & Pensions Moneyfacts August 2013.

## QUESTION 5: PENSION SAVER ENGAGEMENT

**(Call for evidence, paragraph 1.18)**

**We seek views about how far these options (identified in Question 4) meet the needs of savers:**

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

Availability of a greater range of ethical options is, on its own, unlikely to encourage greater engagement with pension saving. Today, the vast majority of UK DC pension savers are invested in a default fund, despite the numerous options available. According to the 2016 edition of The Future Book, published by the Pensions Policy Institute and Columbia Threadneedle Investment, half of master trusts report that 99%[5] of membership is invested in the default fund. This suggests that choice is not the obstacle to greater engagement.

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

Options seeking social impact as well as financial returns may help to encourage greater engagement. In our view, however, a first step needs to be addressing the misconception among many trustees that there is a cost to social investing in terms of a sacrifice of financial return for members.  As outlined previously, DC pension scheme trustees may believe their fiduciary duty prevents them from considering investing socially on behalf of their members. One way of overcoming this may be the introduction of an industry 'kite mark' to help trustees identify funds that offer members the ability to invest socially and also achieve competitive returns.

[5] Pensions Policy Institute, The Future Book second edition 2016

## QUESTION 6: RETURNS FOR SOCIAL INVESTMENT

**(Call for evidence, paragraph 1.18)**

**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?**

We believe that sufficient investment opportunities do exist that clearly evidence the ability to achieve both social impact and financial return. By way of example, three very different investment solutions offered by Columbia Threadneedle are described below, all of which deliver both a social and a financial return for investors:

The **Threadneedle Low Carbon Workplace** (LCW) is a partnership between Columbia Threadneedle, leading commercial developer Stanhope and the Carbon Trust. LCW acquires and then refurbishes properties to best practice low carbon standards and then supports tenants to achieve ongoing energy efficiencies. For investors, it aims to generate strong rental returns while also reducing the carbon footprint generated by commercial property in the UK. Since 2011, LCW has refurbished around 250,000 square feet of office space. On average, LCW's occupiers' emissions are 70 per cent lower than the ECON19 industry benchmark. Across the portfolio, this equates to a saving of approx 3,000 tonnes of CO2 per year. Tenants include housing associations, retailers, financial services and media companies. Such is the demand, that 90% of the projects have been let before completion. LCW manages assets of £250m and as at 30 September 2016 had an annualised return of 9.6%*.

The **Threadneedle UK Social Bond Fund** was launched in January 2014 in partnership with Big Issue Invest, the social investment arm of The Big Issue, the Threadneedle UK Social Bond Fund was the first mainstream investment vehicle that aims to achieve both an investment return and a positive social outcome by investing in bonds issued by organisations that support social and economic development in the UK. Available to small and large investors, with a minimum investment amount of £2,000, the fund invests in a liquid and diversified portfolio of bonds from primarily UK-based organisations that deliver a clear social outcome, supporting socio-economic development in the UK. The fund's social methodology, developed in partnership with Big Issue Invest, focuses on eight fields of social development including employment and training; community services; health and social care; utilities and the environment; transport and communication; financial inclusion; education; housing and property. As at 30 November, the fund had a net annualised return of 6.6%**, delivering on its aim to achieve an annual gross return in line with that of a UK sterling corporate bond index.

The **Threadneedle Ethical UK Equity Fund** is an active equity fund that takes a three-pronged approach incorporating negative screening, best in class and outcome-focused investing. The latter refers to the aim of investing in companies that derive revenue or growth from sustainable outcomes. This approach moves towards the impact investing space, where dollars invested are expected to show real progress in terms of social or environmental goals. The Fund identifies the revenue exposure of a given company to solutions that have the potential and are seeking to deliver sustainable offerings and growth. These include technologies, services and products that provide solutions for environmental sustainability; climate/energy transition; health and wellbeing; safety and security; demographic challenges; education; and communities. The Threadneedle Ethical UK Equity Fund was launched in October 2015 and has achieved an annualised return of 5.7%***.

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

We do not believe savers need to, or should expect to, sacrifice returns for social impact. Further, we feel it is important that this misperception is addressed in order to facilitate better understanding and analysis of the social investment opportunities available to investors.

* as at 30 September 2016, net of fees

** as at 30 November 2016, net of fees

*** as at 30 November 2016, net of fees

## QUESTION 7: FINANCIAL ADVISORS AND SUITABILITY

**(Call for evidence, paragraph 1.22)**

In practical terms, how can financial advisers:

**a) best explore their clients' social motivations?**

Financial advisers currently focus on their clients' financial aspirations and appetites for risk and in the main do not reference their social values or motivations in terms of allocation of capital invested. There is however scope, in the initial client fact-finding process, for advisers to include a question or series of questions relating to social motivations and preferences/areas to avoid. This would help to ensure that clients are offered investment choices that align with their financial needs and also address any appetite to invest socially.

Within the context of a pension scheme, it is important to understand the point at which financial advice is provided and by whom. For medium and larger sized pension schemes this typically involves an employee benefit consultant. The role of the trustees, with the help of the consultant, is to understand the investment needs and beliefs of their members – in some instances this may lead to an investment in social investment strategies. According to the DC Code, trustees are required to survey members to understand their social motivations. The DC code now incorporates the findings of the Law Commission's 2014 report on fiduciary duty, stating that "trustees should take into account environmental, social and governance factors, or ethical concerns, where they believe these are financially relevant. This will ensure that current and future investments take ESG issues into account in order to future-proof their investment strategy". Master trusts have their own trustee bodies whilst contract-based DC schemes (i.e. Group Personal Pensions and Stakeholder Pensions) will have Investment Governance Committees. Smaller employers due to auto-enrol over the next couple of years are likely to use a range of financial advisers and these are likely to opt for off-the-shelf solutions from insurance companies and master trusts.

As highlighted earlier, unfortunately DC pension scheme members' engagement with the investment industry and with their own investment decisions remains low and the majority invest into the default fund. This highlights the need for a truly fit for purpose default fund to include a social investment element. A survey carried out by the Defined Contribution Investment Forum shows that respondents were more likely to favour investments which make a tangible impact on society[6]. If social investments can boost engagement with pension savers it could potentially encourage them to contribute more which is beneficial in terms of the individual's income in retirement and also has a positive impact on society.

**b) present social investment options in a way that is clear, fair and not misleading?**
All investment products need to be presented in a way that makes it easy for advisers and trustees to understand the objective, the investment risk and the expected return outcome. Importantly, this enables retail and institutional investors to compare and contrast similar product/fund types and decide the appropriate fund for their investment. We believe that social investment options should adhere to the same rules of engagement if they are to become credible mainstream options for investors. A consistent approach to the way information is provided will help to dispel the perception that social investing sits apart from other investment decisions, encouraging investors to think of social factors whenever they are considering their investments. In addition to this, providing information in a way that is clear, fair and not misleading brings rigour and transparency to the social investment sector, which will help to further build investor confidence in this segment of the market.

[6] Defined Contribution Investment Forum, Identifying new ways to engage with savers in Defined Contribution Pensions, January 2013

## QUESTION 8: LABELLING SOCIAL INVESTMENT OPTIONS

**(Call for evidence, paragraph 1.23)**

**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?**
Yes, we believe that social investment options should be labelled and described in a standardised way. This is something that already occurs in countries with a more developed social investment market such as France, where social investment products are a more mainstream component of the available investment universe.

We are concerned, however, that the focus is currently on less liquid and therefore less accessible forms of social investment which makes standardisation far more difficult. In order to encourage and facilitate support for a more mainstream social investment market, in which both retail and institutional investors can participate, the focus needs to shift towards the more liquid, regulated investment funds which adhere to social principles and outcomes. This approach has been adopted in many of the countries with more developed social investment markets.

There is also merit in considering the establishment of a specialist social investment organisation to develop a government-backed labelling system that will facilitate the awareness and confidence needed to shift social investment towards the mainstream.

**FURTHER COMMENTS:**

**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.**

Columbia Threadneedle fully supports the Law Commission's work to further the development of the burgeoning social investment sector in the UK and facilitate the progress of social investment towards the mainstream. We feel, however, that the scope of this consultation focuses on niche areas of the market where there is less potential to develop the products/funds that will take social investment into the mainstream.

We share the government's desire to grow the social investment market in the UK. The market is in an exciting early phase, and there is a valuable opportunity to clearly establish and articulate what constitutes social investment. In recent years, we have seen the advent of social impact bonds which have garnered considerable interest. These are, however, niche products which do not lend themselves easily to mainstream investment. Social impact bonds are not in fact bonds in the usual sense; rather they are a mechanism to structure payment-by-results contracts in the social service industry.

Establishing a clear understanding of what constitutes social investment is crucial. A social impact can be achieved by outcomes-based investing using mainstream investment products as long as the social impact is reported in a responsible way. In fact there are already many ethical, environmental, sustainable and social products on offer in mainstream asset classes. In our view this complete spectrum of social products should be fully encompassed and referenced within the Law Commission's work.

In order to drive forward a robust and successful social investment market for UK investors, we believe that the investment industry needs to work with government to develop mainstream equity, bond and property funds that invest for both financial return and social impact.

We welcome the opportunity to work with government and the wider industry to improve clarity, awareness and understanding and increase engagement with the social investment market.

***CONSULTATION ON PENSION FUNDS AND SOCIAL INVESTMENT***

***Closing date for submissions 15th December, 2016.***

*Submission from Fincch*

www.fincch.org.uk

***Fincch is a specialist fund advisor working in the area of charitable care. Fincch has recently established the Charitable Care Investment Fund (CCIF) aiming to raise £400m to invest exclusively in charitable care. Once fully funded, CCIF will rank amongst the world's largest social impact investment funds.***

***Question 1***

***What are the barriers to pension funds investing:***

***(a) In infrastructure generally?***

The nature of security and depth of market knowledge have been the two greatest issues.

Many funds will only invest against an explicit government guarantee. This works - more or less - for Central (CG) and Local Authority (LA) spend but leaves the more innovative areas, particularly those served by charities, CIC's etc out in the cold. There is little formal knowledge of their activities, either in-house with the major pension funds or in the investment consulting firms, and hence the pension funds are reluctant to move first and invest in new asset classes. (This has been a feature of Fincch's fund raising for charitable care, despite a very strong business case and stable underlying assets).

Moreover the established pension funds' social investment managers, post PPI, often look for much higher returns than are generally available in the social investment market segment i.e. in excess of 8%. This in turn cuts out many long term social infrastructure investments, whose effective competitors for the pensions funds' resources should be secured debt products - mortgages, gilts etc - but are often the relatively high returns available in other "impact" categories, especially, wind and photo voltaic power generation.

***(b) In socially significant infrastructure?***
***(c) In other forms of social investments?***

Much work needs to be done to define and characterise "social infrastructure". It includes care facilities, hospitals etc, at one end of the spectrum, across to informal social networks, training businesses etc at the other. The key difference between social and main stream investment, other than the social impact, is in the ability of the investor to secure their investment against "monetisable" assets ie cash flows and disposable fixed assets. In this sense, there is a big difference between "social investment" and "investing socially". In the latter case the infrastructure and activities that are funded have captive assets and cash value, all be it in areas where the risk premium may, allegedly, be hard to assess (care homes, sports facilities etc). Gradually the pensions providers are playing in this space. Legally speaking an effective definition of "Social Assets" as an asset class - on par with "Debt" "Equity" etc - would be very helpful to support those firms, L&G etc, who are active and effective in "investing socially".

The "softer" areas, that are socially vital but asset-poor and/or have questionable cash flows, are very hard to fund in the absence of third party guarantees. (There is a strong case to formalise a social equity guarantee scheme, backed by a combination of philanthropy and commercial finance). Areas including Probation, Mental Health in the Community etc fall into this "social investment" category.

We note that you have considered the French social finance model. The "Sociétés de Cautionnement Mutuelles" are a key part of it. Set up to fund SME's and co-operative agricultural projects, they have grown into major sources of funds that pool risk reserves to provide a further level of security when they lend. A similar approach in the UK to social investment would enable the growth of specialist social sector investors who, in turn, would provide investment opportunities to the major pensions funds.

Moreover we strongly believe that there is a role for specialised bonds - see our attached paper on national care bonds - to fund specific types of asset, be they schools, hospices etc. (Fincch are in discussions with the Bank of England at board level on this issue).

Fincch has also worked in the social impact bond (SIB) area, notably with the Social Stock Exchange, and are confident that SIB's have a role to play in refining approaches and concepts, however, the mechanism does not provide a way to fund replication of successful approaches, which fall back into the traditional CG/LA areas. There is little doubt that the proposed increase in tax allowances in relation to SIB's will drive greater up-take of SIB's - creating an exciting asset class that will provide social and financial returns whilst de-risking CG/LA intervention.

***Question 2***

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

Yes. Some level of definition of social investment would greatly aid both investors and fund managers. At present social investment sits within the alternative investment category and hence is seen as high risk. The funding of much of social infrastructure is not high risk and suffers from current classifications. Equally many social investments produce long term returns (and social benefits) unlike many alternative investments that are predicated on short term cash returns.

Creative legal change, for example making gift aid available on certain social investments, would drive funds into the not-for-profit sector, in addition to the investment itself, thus reducing the risk of project failure - or reducing the total amount of investment required to meet the projects' needs - depending on the nature of the change. This is particularly significant for the creation of a bond market to fund social progress.

***Question 3***

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

We have no firm view on this as specialist social sector entrepreneurs. Anything that impedes the flow of market information, by creating more cumbersome institutions with more bureaucratic decision making processes, is not desirable. On the other hand larger volumes of FUM may make it easier for pension funds to take discrete risks on social investment opportunities. The key issues are market information, transparency and effective scale.

Investment scale is a central issue. The larger pension funds cannot look at individual investments below the level of £30m to £50m. Given that social investments are typically on a smaller scale, the growth of specialist, trusted intermediary funds is a necessary condition for the broader growth of pension fund financed social investments.

Much of current investment in social enterprise has focussed on small scale projects. They have been treated rather like venture capital. There may be some validity in the approach but it has hampered the growth of a social investment industry that focuses on the big issues, including care, the NHS etc.

Scale is the key challenge from both a Treasury and social enterprise perspective. As social investment moves from a way of supporting desirable, local, community initiatives to a part of the mainstream financial system that funds fundamental social infrastructure, CG and LA will need to work closely together to facilitate the scaling up of the business to the benefit of all. As an example, the social housing sector has repositioned itself very effectively and provides one model of the way forward. It is also noteworthy that the sector has used EIB and the Green Bank to leverage pension fund investments. In the absence of EIB, post Brexit, it is clear that some form of UK development bank is needed to support social investment.

***Question 4 - no data on which to base a view.***

***Question 5 - no data on which to base a view.***

***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?***

The distinction you draw is dangerous. "Social impact" and "market" investments are part of one and the same investment environment. In the light of government's inability to fund social infrastructure via the national budget, the projects themselves, individually or grouped in specialist funds, will continue to come to market. The principle challenge is to stabilise and manage the flow of such projects so that as many as possible are successful and the capital markets learn how to fund them. The key issue is how they compete with other investments - which revolves around information, scale and risk, given that returns have telescoped into a fairly narrow range across the market as a whole.

There is a lack of specialist advisors and funds in the social investment space. The development of specialist investment funds and advisors eg in care, education, mental health, etc, should enable the bigger funds to invest via those who have much deeper knowledge of specific market segments. Up to the present there has been a reluctance by the big funds to invest their pension resources in social investments in any way other than directly. Building up the group of specialist investment managers and advisors and fostering their relationships with the major pension funds should radically improve the functioning of the market, directing more funds to the social investment arena.

There is a huge pent-up demand for all types of investment - social and otherwise. Significant amounts of cash are held on corporate balance sheets, in pension funds and privately. The low levels of return in traditional investment sectors have created a market in which the strongest social investment propositions are often more competitive than their "market" sector alternatives.

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

They should not. The majority of such decisions will continue to be taken at fund manager or scheme manager level.

***Question 7 - no data on which to base a view.***

***Question 8***

***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?***

Yes - some degree of standardisation of definitions is needed but the wheel should not be reinvented. An inclusive, rather than exclusive, approach would help. For example, by providing a floor of characteristics that every social investment should have, including an obligation to provide clear social impact statements and assessments of the type used by the Social Stock Exchange in evaluating applications to list.

A standard set of descriptions would be helpful to investors, and necessary if social investment was to attract special tax treatment. Any classification should focus on the nature of what the assets and activities to be funded achieve i.e. the outcomes arising from the investment, other than simple cash returns.

Where impact technologies are involved, eg wind power, it would be sufficient to offer concessions until such time as the technology has matured, along the lines of patent protection. At present wind power may be considered a mature sector, providing solid commercial returns on the basis of a stable technology. The carbon gain could then be traded independently through an independent impact fund.

The classification would take the form of a rolling list as areas of social concern, or impact technologies that, as they mature would become an asset class in their own right.

Each new fund would have to be assessed for its targeted social impact, and regularly reviewed to ensure its continued compliance with those target areas. The Social Stock Exchange already operates such a system for the diverse businesses that it lists. The Commission should look at this system as an example of a successfully operating classification.

***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?***

We believe there is. The current vehicles, Co Ops, Friendly Societies, CIC's etc, are effective from a governance viewpoint but they are circumscribed as to where and how they may invest profits, often defined loosely as "into the community". Clearly the more profitable the organisation, the more desirable it will be as an investment but, if it cannot apply its surpluses into bond or shareholder equivalent income streams, it will struggle to raise external finance, other than from the philanthropic sector or via loans secured on its disposable assets.

We strongly believe that a review of the legislation regulating the social investment sector is desirable, and overdue, as is a review of the tax treatment of both social investments themselves and the returns from them - *vide* the uncertainty around tax relief thresholds on SIB's as a current example.

Standardisation of approach across the various social sector corporate vehicles would be immensely helpful in terms of planning investments, from specialist funds into projects, and in terms of facilitating the merger or reorganisation of charities, CIC's etc to create viable investment vehicles and social enterprises. This is a particular concern in the charitable care sector where smaller charities will need to merge in order to pool their assets and raise funds against them

This presupposes the continued professionalisation of the social sector and the maintenance of levels of governance commensurate with the greater sophistication of financial risks the sector will be exposed to.

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**THE LAW COMMISSION**

**PENSION FUNDS AND SOCIAL INVESTMENT**

This optional response form is provided for consultees' convenience in responding to our call for evidence on pension funds and social investment.

The response form includes the text of the questions in the call for evidence, with boxes for yes / no answers (please delete as appropriate) and space for comments. You do not have to respond to every question. Comments are not limited in length (the box will expand, if necessary, as you type).

Each question gives a reference in brackets to the paragraph of the call for evidence at which the question is asked. Please consider the surrounding discussion before responding.

We invite responses from 7 November 2016 until **15 December 2016**.

Please return this form:

By email to: commercialandcommon@lawcommission.gsi.gov.uk.

By post to: Lucinda Cunningham, Commercial and Common Law Team,
Law Commission, 1st Floor Tower,
Post Point 1.53, 52 Queen Anne's
Gate, London SW1H 9AG

We are happy to accept responses in any form. However, we would prefer, if possible, to receive emails attaching this pre-prepared response form.

| **Freedom of information statement** |
|---|
| Any information you give to us will be subject to the Freedom of Information Act 2000, which means that we must normally disclose it to those who ask for it.<br>If you wish your information to be confidential, please tell us why you regard the information as confidential. On a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not be regarded as binding on the Law Commission.<br>***The Law Commission processes personal data in accordance with the Data Protection Act 1998 and in most circumstances it will not be disclosed to third parties.*** |

**YOUR DETAILS**

| Name: | |
|---|---|
| Organisation: | Institute and Faculty of Actuaries |
| Role: | |
| Postal address: | |
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**CONFIDENTIALITY**

Do you wish to keep this response confidential?

| Yes: | No: X |
|---|---|
| If yes, please give reasons: | |

## QUESTION 1: BARRIERS TO PENSION FUND INVESTMENT

(Call for evidence, paragraph 1.15)

What are the barriers to pension funds investing:

(a) In infrastructure generally?

(b) In socially significant infrastructure?

(c) In other forms of social investments?

(a) In infrastructure generally

Debt investment generally provides 80 to 90 percent of the capital for infrastructure projects, with just 10 to 20 percent coming from equity. The small proportion of infrastructure investment coming from equity can be problematic as it is crucial at the early stages of a project and in determining whether the project will go ahead. The imbalance between debt and equity investment is a result of pension funds preferring to invest in projects that are past the early stages of development and are therefore perceived to be lower risk. With investor appetite greater for those projects in their later stages, there is a shortage of an infrastructure 'pipeline'. For many investors it is important to have a sustainable 'pipeline' of infrastructure projects, so that this asset class can fit into a coherent, long-term investment strategy, which maximises long-term returns and provides necessary liquidity.

*(b) In socially significant infrastructure and (c) In other forms of social investments*

There remains a strong perception that the financial returns on social investments will tend to be lower and risks higher than on similar but unrestricted investments. As noted by the Law Commission, pension scheme trustees generally consider short-term financial returns and risks to be their predominant concern in making investment decisions. In addition, the legal provisions allowing trustees to consider longer-term and other factors are not well understood by trustees, or often by investment advisers.

Socially significant infrastructure and other forms of social investments are less available than other generic asset classes. This forces investors and investment advisers to actively seek these investment opportunities and this remains uncommon.

In addition, trustees tend to be risk averse and the regulatory framework can encourage herd mentality. This leads to difficulty in encouraging occupational pension schemes to invest in more unusual investments, which social investments are currently perceived to be.

One way to encourage investors to commit funds to infrastructure or other forms of social investment would be to better able investors to assess whether the investment is 'bankable'. This can be defined as having accurate, up to date, sufficient and wide-ranging information and analysis to allow investors to commit funds to a project. Before committing resources, investors will

undertake their own due diligence assessments and they will need to see evidence of a project's feasibility and expected return. This requires sufficient accurate and up to date information to allow investors to analyse the risk of a project. If those seeking capital for these types of investments were to apply a risk management approach, it would help to generate this information and in turn demonstrate that an investment is 'bankable'. In particular, if the investment were viewed over the longer term, the benefits of social investment would become more apparent.

There are examples where pension funds have committed funds to forms of social investment, which could be useful in setting precedent for other funds. Some local authority pension funds have committed funds to social housing using special purpose vehicles in order to focus investment where they intended.

## QUESTION 2: LEGAL AND REGULATORY BARRIERS

(Call for evidence, paragraph 1.15)

Do any of those barriers (identified in Question 1) relate to issues of law and regulation?

| Yes: those relating to trustees' fiduciary duties to focus on financial returns | No: | Other: |
|---|---|---|

The call for evidence states in Section 1.5:

*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.*

If it is the intention that consideration of non-financial factors should be acceptable, provided there is not a significant increase in risk of financial detriment compared to similar financial investments, the law, or its interpretation, could helpfully be amended so this is made explicit.

As the law is currently drafted, we suggest that it may deter social investment as trustee bodies may be reluctant to state that there was no risk of financial detriment when taking non-financial factors in consideration, even if they were of the opinion that there was no more risk than in a comparable standard investment.

## QUESTION 3: SIZE OF PENSION FUNDS

(Call for evidence, paragraph 1.15)

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

| Yes: | No: | Other: Whilst larger pension funds may be better able to assess social investments, they will be more likely to look for investment managers to do this on their behalf. |
|---|---|---|
| At present, only very large pension schemes are likely to have the expertise and interest to assess social investments, particularly as each tends to have different characteristics, meaning comparability remains difficult. In addition, many social investments are themselves relatively small and this can mean they are time and resource consuming to research and manage, as well as making it difficult to divest. Even larger projects are not without difficulty, for example, projects such as HS2 and Hinckley Point require a consortium of investors. We have seen that scale can be achieved through joint investment vehicles, for example, the recent local authority groupings and the Pensions Infrastructure Platform. | | |

**QUESTION 4: ETHICAL PENSION OPTIONS**

(Call for evidence, paragraph 1.18)

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: PENSION SAVER ENGAGEMENT

(Call for evidence, paragraph 1.18)

We seek views about how far these options (identified in Question 4) 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?

<table>
<tr><td>Yes:</td><td>No:</td><td>Other: We encourage the Commission to gather further evidence, it may be that different approaches are more appropriate in different circumstances</td></tr>
<tr><td colspan="3">Long-term financial planning is inherently complex. With this in mind, our members had a range of views on which approach would be more appropriate. We therefore encourage the Law Commission to undertake further analysis on whether a separate fund option, or an overall social investment objective, would best achieve its aims. We consider there to be merit and risk in both approaches and we would welcome the opportunity to arrange for the Law Commission to meet with our members to discuss this range of views should it be helpful to the Commission.<br><br>For a greater range of options:<br><br>To introduce investments with social impacts, it may be more successful to have them as a separate option. As noted in the call for evidence, many individuals, in particular of the “millennial” group, are likely to be much more engaged in social investment, where standard DC pension investment is of limited or no interest.<br><br>For options incorporating social impact:<br><br>In DC schemes, the increasing popularity of target date funds (and other similar investment options), where the provider can manage the asset mix over time within an overall investment objective creates an opportunity to encourage/enable social investment. The target date fund could (at least partly) be invested for social aims, provided this was not expected to be at the expense of financial returns. This seems similar to the French example in the consultation paper.<br><br>Social investment often has broad aims that are not individualistic in the way that ethical investment aims are. Hence social investment is not as problematic as ethical investment, making it feasible to include in core DC funds like target date ones.</td></tr>
</table>

## QUESTION 6: RETURNS FOR SOCIAL INVESTMENT

(Call for evidence, paragraph 1.18)

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?

| Yes: | No: there are not currently, nor should savers be prevented from sacrificing returns for social impact as long as the trade off is clear. | Other: |
|---|---|---|
| The number of investments providing both social impact and market returns remains small, and most potential investors have no easy way of accessing them. It is not clear how far this market could be developed, as there are very few examples at present.<br><br>However, should this market develop, we consider it important that funds have a clear prospectus, where the objectives and criteria are clearly set out. We believe that savers should not be prevented from sacrificing financial returns for social impact, as long as they understand the trade off being offered. Where an individual has a choice, any investment decision should be informed. To make the difference clear without overwhelming savers with information, it may be helpful to provide separate routes following either 'social-impact first', with decisions available on types of impact and acceptable levels of potential return, or 'financial-return first', with social impact addressed in a method more consistent with current ESG (economic, social, governance) approaches. | | |

## QUESTION 7: FINANCIAL ADVISORS AND SUITABILITY

(Call for evidence, paragraph 1.22)

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?

| (b) |
|---|
| To do this effectively, an adviser would need considerable knowledge of the social investments available, as well as how those compare both to each other.<br><br>Until the concept is firmly entrenched in savers' awareness, any exploration of social |

| investments is likely to need to be considered as a separate matter from financial investments. In the long-term, a consistent way of comparing social investments that can also be applied to standard financial investments' ESG characteristics would greatly increase transparency. It would also ensure sufficient understanding around the social impact received in exchange for (potentially) reduced returns. |
| --- |

**QUESTION 8: LABELLING SOCIAL INVESTMENT OPTIONS**

(Call for evidence, paragraph 1.23)

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?

| Yes: Some kind of standardisation is essential for social investment to become available to a non-specialist audience. | No: | Other: |
| --- | --- | --- |
| This is likely to need to start with qualitatively, categorising different types of impact and the (qualitative) level of risk and certainty around both the social and financial impacts. This could be done similarly to how financial investments are categorised by industry, geography, and risk and return profiles. They should be clearly described in terms of objectives and criteria to be adopted in making investment in social projects, the likely impact on returns and any impact on liquidity.<br><br>Other investment platforms, for example crowd-funding platforms, are already presenting the potential risk and rewards for social investments in an engaging manner, from which DC pension funds can learn. | | |

**QUESTION 10: LAW OF SOCIAL ENTERPRISES**

(Call for evidence, paragraph 1.25)

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?

| Yes: | No: | Other: |
| --- | --- | --- |
| | | |

**FURTHER COMMENTS:**

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.

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THE
INVESTMENT
ASSOCIATION

A response by The Investment Association to the Law Commission's Call for Evidence on Pension Funds and Social Investment

December 2016

## Introduction

The Investment Association[1] welcomes the opportunity to respond to the Law Commission call for evidence, following the previous paper on fiduciary duty. The consultation raises a range of pertinent questions, particularly as the debate continues on the development of default DC arrangements.

We set out at this stage a number of general considerations from an investment management perspective. We would be very pleased to discuss these issues in more detail with the Commission in due course.

## Section One: Fiduciary Duty and Default Funds: Some Broad Considerations

It is useful to recognise immediately some fundamental distinctions between defined benefit (DB) and defined contribution (DC) pension schemes, which have significant implications for investment decision-making and, in our view, for the discussion about fiduciary responsibility.

DB schemes are a classic institutional investment vehicle. Scheme members benefit from an employer commitment related to earnings, make no investment decisions and carry no direct investment risk (although clearly there are solvency and associated adequacy risks). The reality, therefore, of a trustee debate about the nature of socially responsible investment relates not to the impact upon directly borne member risk and benefits, but to the potential impact upon scheme returns and funding costs which indirectly affect members.

In contrast, for a pure DC scheme (i.e. a unit-linked arrangement in which there is no collectivisation of contributions or benefits), there are three key differences:

- Investment risk is borne directly by the member;
- A degree of investment choice is usually available; and
- Members may choose to vary contributions significantly according to their savings plans. This variation in contributions may take place either in the context of a default investment arrangement or self-select funds.

The majority of DC scheme members do not currently self-select, opting either passively or actively for a default arrangement[2]. In a trust-based scheme, the scheme trustees will have responsibility for this default arrangement, which will be perceived by some as advice whereas in reality it is the result of a best efforts decision-making process that is not always subject to a detailed test of individual circumstances and preferences.

This raises some important issues about investment exposure that trustees will need to consider when deciding whether to adopt an approach that has specific environment, social or governance (ESG) criteria. These relate to how/whether to reflect an aggregate preference among scheme members for a certain kind of default arrangement, what (if any) implications there may be for those members of the scheme who do not favour this approach but who might otherwise be in the

[1] The Investment Association represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the in-house managers of occupational pension schemes. They are responsible for the management of around £5.7 trillion of assets in the UK on behalf of domestic and overseas investors.
[2] Anywhere between 70 and 99 per cent of members are in the default strategy, with variation across scheme type. Source: PPI, 'The Future Book: Unravelling workplace pensions 2016 Edition'

default, and the associated communications across the membership base. These considerations may be complex within a single employer scheme, and could become even more difficult to manage across multi-employer arrangements that aggregate the savings of very different groups of savers.

One particular practical difficulty, to which we return in the third section, is a clear definition of responsible investment, whether very targeted 'deep green' approaches which screen in or out of specific investments according to a narrowly defined set of environmental themes or broader ESG approaches which look across a range of criteria for every company in the portfolio. One example of this from the UK debate is the inclusion historically of gambling companies in the FTSE4Good index. For some, this may be perfectly acceptable on the basis of specific ESG tests, but a number of individual and institutional investors with specific ethical investment preferences would class gambling as unacceptable.

Indeed, even the terminology is varied and evolving, as this section has illustrated. The original Investment Management Association flags in this area focused on 'ethical' investment. Socially Responsible Investment (SRI) also emerged as a widely used term before evolving into ESG, which encompasses a series of what could in theory be quite distinct priorities.

At scheme level, therefore, designing a default or even a range of options for those favouring some form of ESG-based investment may be challenging. Nonetheless, it is certainly feasible to do so. NEST, for example, includes an Ethical Fund[3] to cater for members who have specific concerns about the impact that organisations have on the environment and society, for example in areas such as human rights and fair trade. This fund invests in companies with positive track records on human rights, fair labour practices, fair trade policies and the environment, while avoiding companies that manufacture tobacco products, cause damage to the environment, are involved in the manufacture of arms and weapons of mass destruction and co-operate with corrupt states and those with a bad human rights record.

Referencing the discussion earlier, the challenge that this poses for fiduciary duties in the context of maximising member outcomes is captured by the recognition that members who invest in this fund are usually exposed to slightly higher risk than with default arrangement, owing to lower degrees of diversification of securities and asset classes than with the default. However some would argue that this increased risk is off-set or outweighed by the reduced risk of ESG issues impacting upon the return of the portfolio.

## Section Two: Barriers to Investing

The current consultation groups together what we believe are very different kinds of investment, which in turn can be accessed in multiple ways. We set out below some considerations with respect to the three areas identified in the consultation: infrastructure generally; socially significant infrastructure; and other forms of social investment.

Infrastructure, social utility and investibility

To some extent, all infrastructure necessary for the operation of society (schools, roads, rail, housing) has a social utility almost by definition. However, aspects of infrastructure provision could

[3] Further information is available on the NEST website.

have a strong social utility and profoundly cut across other ESG considerations: e.g. a power-generating dam in an environmentally sensitive area.

Some infrastructure also addresses quite specific distributional issues, notably social housing with controlled rents or shared ownership rules and/or defined access criteria for low income and/or certain professional groups. We would use the term 'social infrastructure' for this category of investment.

Whether specifically socially focused or part of a wider public good framework, infrastructure can be accessed in a number of ways, both directly through ownership of the underlying asset (e.g. property) or through equity and/or debt exposure. While underlying infrastructure is illiquid, different degrees of liquidity can be obtained using equity and debt holdings, as well as structures such as closed-ended funds or listed infrastructure companies. In short, access to infrastructure does not have to involve an inherently illiquid holding. However, liquidity will come with conditions and some form of price: for example, a closed-ended property fund may trade at a significant discount to net asset value at times of high market stress. More generally, there is a trade-off between the degree of liquidity and the illiquidity premium generated for investing in illiquid assets.

The question of whether DC schemes can access infrastructure is really two-fold:

- Are there constraints on DC schemes specifically relating to the nature of their structure, regulatory architecture and investor base that prevent them from accessing infrastructure?
- Is there an adequate supply of investible infrastructure that can satisfy the needs of long-term investors, whether insurers, pension schemes or others?

The Investment Association has views on both areas:

- Constraints on DC schemes The DC charge cap of 75bps is a limiting factor because infrastructure is typically more costly to access than the liquid, listed assets more commonly found in DC scheme. While the cap only applies in respect of the default strategy in practice it covers the vast majority of DC membership since participation in the default is so high. This presents asset allocators with problems when it comes to investing in alternative or illiquid asset classes – the budget simply does not allow for it.

  Another regulatory constraint on DC schemes comes in the form of the FCA's permitted links rules, which, given the dominance of unit-linked life funds as the delivery vehicle of choice for DC investments, govern the availability of investment options to DC investors. This is relevant to the debate on alternative investments in DC because it limits the fund holdings in a unit-linked fund to authorised UCITS and NURS funds. Alternative asset classes are typically in other fund structures that would be prohibited by the permitted links rules.

  A non-regulatory barrier to the use of alternative and illiquid assets in DC cited by market participants is the prevalence of daily trading and pricing for DC funds. There is no regulatory requirement that dictates DC funds must have daily trading; instead it is the result of the evolution of the DC market and the operational systems put in place on the insurance platforms that are host to so many DC funds. It does raise some challenging issues with respect to underlying assets that can neither be priced nor traded on a daily basis.

- Investibility and infrastructure While DC schemes certainly have a number of constraints, there are supply side as well as demand side issues to consider in the infrastructure debate. There is

already evidence of a mismatch between the level of potential pension/institutional investment available for infrastructure and the supply of suitable projects. This raises wider questions that are already the subject of dialogue among key stakeholders, including investment managers and asset owners. Lack of clarity of pipeline and the danger of 'crowding out' of private investors in the context of public sector institutional funding (e.g. EIB) are particular issues here.

It is also the case that the broader concern about availability of capital market funding for infrastructure funding can be addressed through new conduits, such as municipal bonds which would allow local authorities to raise money. The Investment Association supports the development of such a market and has recently released a paper on the subject[4].

While greater levels of infrastructure investment by UK pension schemes, including DC schemes, make sense for both institutional investors and the wider economy, there are also other reasons to support further development. Millions of individuals who find themselves in many respects unexpectedly investors as a result of automatic enrolment struggle to navigate the investment landscape. One expression of this is a tendency to default arrangements. Infrastructure exposure could have the positive benefit of providing greater tangibility – e.g. funding for regional development where savers see the results in their localities – where abstract news of stock markets rising or falling can mean little and be alienating for the uninitiated.

However, this is not without its risks and brings the debate back to fiduciary responsibility. There will inevitably be some political pressure at some moment – whether local or national – to 'invest in Britain' with respect to infrastructure projects or possibly to social investment programmes (see below). If undertaken in a prudent, well-governed manner, this kind of exposure could be valuable from both an economic and broader perspective as set out in the previous paragraph. However, there are obvious dangers, partly highlighted in the reluctance among institutional investors to take on major greenfield transport infrastructure projects with early stage construction risk.

Social investment (non-infrastructure)

We highlighted in earlier comments a range of definitional issues with respect to what is broadly referred to as ESG investment. There are also certain kinds of enterprise or hybrid organisation that are focused on social impact before profit. We would refer to these as 'social impact' to delineate this focus from the wider range of ESG considerations that could result in an employer being designated as socially responsible. The latter may include quite broad criteria with respect to treatment of employees. While social impact investing may well see a similar emphasis, the overall economic purpose is likely to be far more targeted.

We see no inherent reason why DC schemes should not seek to invest in social impact projects. However, for a default arrangement, schemes will inevitably do this in the context of the broader debate about the meaning of fiduciary responsibility and the nature of the saver population.

In particular, if there were to be a trade-off between maximising return and investing in social impact projects, fiduciary duty might lead DC governance bodies to conclude that the default

[4] 'Investors Encourage the Development of a UK Municipal Bond Market', IA, November 2016. Available to view on the IA website.

strategy should aim to maximise risk-adjusted returns, given the investor bears all the risk, with social investment being an alternative option that DC savers could actively choose to invest in outside the default strategy.

## Section Three: Exercising Choice / Clarity of Definitions

The consultation raises a number of questions about how guidance can work for those who are not in default schemes and who are actively deciding where to save. This could be both those using DC platforms with a wide range of choice or retail savings platforms.

The issue here is arguably more straightforward than default design where there is a major challenge of aggregated preferences. However, both the default design decision and the retail selection decision raise the question of definitional clarity. We do not believe it is straightforward to put a degree of standardisation in this area for reasons partly set out above.

Ultimately, this is a deeply complex area. The Law Commission observation (para 1.16) about how millennials may have quite a distinct emphasis is a useful acknowledgement of this complexity. Different individuals and institutions will inevitably have very different interpretations and this goes well beyond generational issues. Examples of historic debates have included whether some armaments companies could be considered acceptable for ethical investment given the shift in the 1990s towards Western intervention in humanitarian crises and the focus away from frontline combat equipment by some military hardware manufacturers.

It is certainly possible to set a broad framework and this has already been undertaken in the UNPRI initiative. A framework creates the possibility of a common language even if preferences and emphasis vary.

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**PENSION FUNDS AND SOCIAL INVESTMENT**

This optional response form is provided for consultees' convenience in responding to our call for evidence on pension funds and social investment.

The response form includes the text of the questions in the call for evidence, with boxes for yes / no answers (please delete as appropriate) and space for comments. You do not have to respond to every question. Comments are not limited in length (the box will expand, if necessary, as you type).

Each question gives a reference in brackets to the paragraph of the call for evidence at which the question is asked. Please consider the surrounding discussion before responding.

We invite responses from 7 November 2016 until **15 December 2016**.

Please return this form:

By email to: commercialandcommon@lawcommission.gsi.gov.uk.

By post to: Lucinda Cunningham, Commercial and Common Law Team, Law Commission, 1st Floor Tower, Post Point 1.53, 52 Queen Anne's Gate, London SW1H 9AG

We are happy to accept responses in any form. However, we would prefer, if possible, to receive emails attaching this pre-prepared response form.

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## YOUR DETAILS

| | |
|---|---|
| Name: | [redacted] |
| Organisation: | Tintagel House (Sheffield) Ltd. Charity |
| Role: | [redacted] |
| Postal address: | [redacted] |
| Telephone: | [redacted] |
| Email: | [redacted] |

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**QUESTION 1: BARRIERS TO PENSION FUND INVESTMENT**

(Call for evidence, paragraph 1.15)

What are the barriers to pension funds investing:

(a) In infrastructure generally?

(b) In socially significant infrastructure?

(c) In other forms of social investments?

a), b) and c)

Fear that the trustees could be sued if the investment loses money.

No clear understanding that there would be protection against liability.

**QUESTION 2: LEGAL AND REGULATORY BARRIERS**

(Call for evidence, paragraph 1.15)

Do any of those barriers (identified in Question 1) relate to issues of law and regulation?

| Yes: x | No: | Other: |
|---|---|---|

## QUESTION 3: SIZE OF PENSION FUNDS

(Call for evidence, paragraph 1.15)

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

| Yes: | No: | Other: |
|---|---|---|
| | | |

## QUESTION 4: ETHICAL PENSION OPTIONS

(Call for evidence, paragraph 1.18)

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: PENSION SAVER ENGAGEMENT

(Call for evidence, paragraph 1.18)

We seek views about how far these options (identified in Question 4) 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?

| Yes: x | No: | Other: |
|---|---|---|
| Yes definitely. | | |

## QUESTION 6: RETURNS FOR SOCIAL INVESTMENT

(Call for evidence, paragraph 1.18)

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?

| Yes: | No: | Other: |
|---|---|---|

a) YES – but if more pension funds were to invest, and appropriate growth in such markets would be needed.

b) b) Not in the slightest. As long as they are acting with reasonable care.

No one can predict the future !

**QUESTION 7: FINANCIAL ADVISORS AND SUITABILITY**

(Call for evidence, paragraph 1.22)

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?

Speak to those who already do it well

**QUESTION 8: LABELLING SOCIAL INVESTMENT OPTIONS**

(Call for evidence, paragraph 1.23)

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?

| Yes: x | No: | Other: |
|---|---|---|
| Yes. | | |

**QUESTION 10: LAW OF SOCIAL ENTERPRISES**

(Call for evidence, paragraph 1.25)

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?

| Yes: X | No: | Other: |
|---|---|---|
| Definitely | | |

**FURTHER COMMENTS:**

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.

Well done for taking this initiative forward !!

Timely, important and forward looking...

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**PENSION FUNDS AND SOCIAL INVESTMENT**

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**YOUR DETAILS**

| | |
|---|---|
| Name: | |
| Organisation: | Legal & General Investment Management |
| Role: | |
| Postal address: | |
| Telephone: | |
| Email: | |

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|---|---|
| ~~Yes:~~ | No: |

If yes, please give reasons:

**QUESTION 1: BARRIERS TO PENSION FUND INVESTMENT**

(Call for evidence, paragraph 1.15)

What are the barriers to pension funds investing:

(a) In infrastructure generally?

(b) In socially significant infrastructure?

(c) In other forms of social investments?

a) **In infrastructure generally**?

The following are some of the barriers pension funds encounter in the consideration of allocating capital to infrastructure investments:

**Liquidity requirements**: although DC pension flexibility changes (in particular the removal of annuity requirements) have reduced the emphasis on managing short-term liquidity requirements, obstacles remain in this area.

In the case of a Trust-based scheme, the trust deed is likely to limit the types of investment allowed by the trustees. Given the requirement (although often implicit rather than explicit) for daily liquidity, illiquid alternatives would fall foul, among other things such as the eligibility of vehicle.

Daily dealing requirements under Permitted Links Regulation for Life Company Funds restrict the ability of pension funds to diversify investments into a broader range of asset classes. Please see more in question 2.

For all types of scheme, consideration also needs to be given to the fact that members have a statutory right to transfer to other schemes. For DC schemes, this right applies at any time. For DB, the right only applies when someone has left pensionable service. Legislation currently states that these should generally be processed within a six month timeframe. If not, the

scheme manager or trustees could be subject to financial penalties. Schemes would need to ensure this is taken into account when choosing investments.

**Investable size and aggregation**: matching the size of available infrastructure investments and the availability of capital from pension funds can be a challenge. Infrastructure aggregation may be necessary in order to ensure sufficient scale for pension fund investments.

**Political risk**: political risk remains a key factor in consideration of infrastructure investments, both in the UK and globally. Governments need to provide a stable platform for the long-term in order for investors to be able to commit their capital to LT infrastructure investments.

**Supply of assets**: Scale requires a sufficient supply of infrastructure investment opportunities, with an appropriate risk/return profile. Insufficient supply results in crowding of capital into a limited number of investments, and therefore lead to potential over-pricing.

**Charges and value for money**: Schemes being used by employers to meet their automatic enrolment duties (known as 'qualifying schemes') must restrict the total charge borne by members on the default investment to no more than 0.75% per annum. This includes the cost of administration and of managing the investment strategy (but excludes investment transaction costs). If the cost associated with infrastructure investment exceeds this level, schemes would not be able to use such an option as their default. They could potentially make it an option available for individual member choice (although this may not be a commercially viable as the majority, c. 90% of members are in the default). Outside of automatic enrolment, whilst there is no formal charge cap, trustees and independent governance committees have a general duty to assess whether all investment solutions provide value for members. Governing bodies would therefore need to be able to make that assessment when considering infrastructure investment.

The Department of Work and Pensions is to review automatic enrolment in 2017, and this will include a review of the charge cap. It will assess whether the level of the cap should be changed and whether some or all transaction costs should be covered by the cap. DWP is expected to engage with stakeholders in early 2017.

**Investment Platforms**

The DC committee of the Investment Association has a working group meeting to look at the use of Alternatives in DC, including infrastructure. One of the issues being looked at is the operational challenges with illiquid investments.

Illiquid investments present a range of system/operational challenges; engagement with investors so far suggests that these can be overcome; however they need to see client demand in order to justify the costs.

**Solvency II capital requirements:** Solvency II capital requirements were also discussed in the DC Committee of the IA. This was in relation to life wrapping these funds and questioning what the treatment would be with regards to capital adequacy reserve requirements. For example, if infrastructure is treated as equity-like, this translates to a negative capital requirement from the platform point of view. It was pointed out that NEST is not a Life Co and manages TDF's and intends to invest in infrastructure; TDF's would certainly have greater flexibility on this matter.

b) **in socially significant infrastructure**:

A lack of understanding and/or consensus as to what constitutes socially significant infrastructure is the first barrier to investment. Further clarity is required on the particular types of infrastructure that are considered socially significant, and improved articulation/measurement of their social impact is required.

A lack of appetite for ethical/social investments from pension schemes is another factor. C. 90% of members opt for the default fund. The reasoning behind this lack of demand needs to be evaluated and addressed. In question 5 below, we highlight some of these issues and put forward suggestions to broach them.

c) **in other forms of social investments**?

As above, a lack of understanding and/or consensus as to what constitutes a social investment is the first barrier to investment. Further clarity is required on the particular types of investments that fall under the umbrella of social investments.

Linked to this is the question of impact. It is unclear as to the level of impact required in order for an investment to be considered a social investment.

| Impact-measuring tools need to be sufficiently sophisticated and comparable to monitor this impact and to enable effective communication with members on the social utility of their investments. This also blurs the line with other asset classes which are delivering their own "social investment"- socially responsible funds in equities and green bonds etc.<br><br>A lack of appetite for ethical/social investments from pension schemes is again a factor. 90% of members opt for the default fund. The reasoning behind this lack of demand needs to be evaluated and addressed. Please see question 5. |
|---|
| |

**QUESTION 2: LEGAL AND REGULATORY BARRIERS**

(Call for evidence, paragraph 1.15)

Do any of those barriers (identified in Question 1) relate to issues of law and regulation?

| Yes: ✓ | No: | Other: |
|---|---|---|
| **<u>Permitted Links Regulation</u>**: daily dealing requirements for Life Company Funds under the Permitted Links Regulation restrict the ability of pension funds to diversify investments into a broader range of asset classes. Weekly requirements would also be limiting. We'd therefore suggest a weekly pricing based on the latest valuation, but monthly for the dealing, as a minimum.<br><br>As mentioned above, the DC committee of the Investment Association has a working group meeting to look at the use of Alternatives in DC, including infrastructure. Another of the issues the Committee is looking at is that of daily pricing, vs. daily trading. Daily trading is currently allowable – meaning it is possible to set estimated prices daily with the assumption that there is not daily trading volatility. However, further review suggests that while daily estimate pricing is appropriate for shorter periods, a liquidity mismatch is not | | |

sustainable over a longer period, for example a quarter.

The observation has therefore been made that daily pricing is more a retail requirement, whereas institutional investors are long-term, so the liquidity requirements should be eased.

**Fiduciary Duty**: We welcome the clarifications made by the Law Commission around ESG and fiduciary duty. However, there remains a general misunderstanding of what ESG is amongst most of the pension community. This, accompanied by the Pension regulator specifically stating that further clarification of the law is not required in this regard, is not helping the agenda of socially useful investments that also provide adequate investment returns.

**Oversight of investment consultants**: There is a lack of oversight of investment consultants with regards to how they assist the development of responsible investment strategies, including social investments.

**Statutory transfer right**: The need for trustees to exercise a transfer request within six months is outlined in section 99 of the Pension Schemes Act 1993.

**Charges and value for money**: The requirement to cap charges and assess value for money are, for trust-based schemes, contained in the Occupational Pension Schemes (Charges and Governance) Regulations 2015, and for contract based schemes within the FCA's Conduct of Business Sourcebook.

The issue is also being looked at by the working group committee of the IA, 'The Use of Alternatives & Illiquids in DC'. The observation has been made that unless alternative illiquid investments can fit within the existing 75bps price cap, they will need to be allowed outside the cap – as is the case with insurance guarantees.

## QUESTION 3: SIZE OF PENSION FUNDS

(Call for evidence, paragraph 1.15)

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

| Yes: ✓ | No: | Other: |
|---|---|---|

The size of funds is an issue and legal obstacles do remain.

In the case of a Trust-based scheme, the trust deed is likely to limit the types of investment allowed by the trustees. Given the requirement (although often implicit rather than explicit) for daily liquidity, illiquid alternatives would fall foul, among other things such as the eligibility of vehicle.

As above, daily dealing requirements under Permitted Links Regulation for Life Company Funds restrict the ability of pension funds to diversify investments into a broader range of asset classes.

Small trust-based schemes typically have very limited governance and are usually heavily dependent on their EBC for investment advice. They have little or no economies of scale regarding prices and often Alternatives (apart from queues, commitment drawdowns, possible gates etc.) require larger minimum subscriptions than small schemes. For instance the minimum of our newly launched build to rent Fund (a fund that should tick the social pension box) is £10m.

A multi-employer Master trust should provide the required economies of scale, however we understand would still fall foul of Permitted Links and any Master Trust deed restrictions in relation to use of alternative vehicles and illiquid investments.

## QUESTION 4: ETHICAL PENSION OPTIONS

(Call for evidence, paragraph 1.18)

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?

The lack of a definitive list of terminologies within the industry is one of the key barriers to pension funds allocating capital to social investments. Terms such as ESG investing, ethical investing, social investing, impact investing etc. are used interchangeably. This creates confusion and leads to a lack of understanding as to what is to be achieved at the level of risk and return, societal impact or ethical persuasion.

This makes it difficult for pension trustees to differentiate between responsible investment strategies and products which address issues that could fall under their fiduciary duty and those that do not. The lack of a common framework also makes it more difficult to create demand for responsible investment strategies and products more broadly; both at the trustee and member level. We would like to offer insight into how LGIM defines different types of responsible investment strategies.

| Responsible Investment | | | | | |
|---|---|---|---|---|---|
| | Stewardship Corporate governance | ESG Integration | Ethics | SRI/ESG/ thematic funds | Impact funds |
| Bottom-up | bottom up analysis ESG not yet priced in by the market | bottom up analysis ESG not yet priced in by the market | | bottom up analysis ESG not yet priced in by the market | what companies produce |
| Top- down | market behaviour, regulatory changes | top down allocation into sectors who are set to lose/win from ESG driven market trends | sector/themes allocation | top down allocation into sectors who are set to lose/win from ESG driven market trends | top down allocation into societally positive trends |
| Who decides | asset manager | asset manager | asset owner | asset owner | asset owner |
| Examples | voting against misaligned pay, listing rules | lack of board independence, fatality rates | tobacco, weapons | climate, technology | green bonds |
| Funds impacted | mainstream funds | mainstream funds | exclusion/reduced universe | best in class, renewables | new funds and reporting |
| How | voting, engagement | risks assessment | buy in external bonafide list | proprietary expertise | societal impacts |
| Outcome expected | enhanced beta / reduce risks | enhanced alpha /reduce risks | no exposure to certain themes | similar risk-adjusted returns | societal impacts - risk-adjusted returns |

The biggest issue is the difference between ethics – mainly done through assessment of ethics – and financially material ESG aspects. This is a huge barrier that is making the industry stagnate in the current state.

Positive social impact does not have to make you lose money, but that is the overwhelming consensus in the industry. Again, lack of legal clarity and appropriate definitions means that any types of investment that are associated

with social benefits would continue to suffer.

a) **What ethical DC pension funds are available**?

Again, the use of ethical in this question has suddenly narrowed the scope of this consultation.

Ethical funds are extremely limited in terms of client take-up rate, and therefore the options are also limited.

The table below lists the responsible investment index funds offered by LGIM. The funds listed fall under our responsible investment strategy, with limited offering in the "ethical" space which is done with pure exclusions.

| Index Strategy | Launch Date |
|---|---|
| **Ethical and ESG integration** | |
| FTSE4Good Global | April–03 |
| FTSE4Good Global* | Feb–15 |
| FTSE4Good Global (Bespoke)* | July–15 |
| FTSE4Good UK | Dec–02 |
| L&G Ethical Trust | Aug-00 |
| **Ethical (Ex-Tobacco)** | |
| FTSE World Developed (ex Tobacco) Index | Feb-14 |
| FTSE All-Share ex Tobacco Index | Dec-14 |
| **SRI Thematic - Carbon Efficient** | |
| MSCI World Low Carbon Target | Mar-15 |
| **SRI Thematic - Carbon Efficient with Stewardship** | |
| Future World Fund (factor based) | Nov-16 |
| **Bespoke Index** | |
| Custom Client Specific ESG Screened Index* | Nov-05 |

It should be noted that these are all equity funds. The lack of attention given to the role of fixed income in responsible investment needs to be addressed; this will be particularly relevant when looking at impact funds focusing on social investment.

**b) What proportion of people take them up?**

The uptake of the ethical funds is low, representing less than 0.1% of LGIM assets under management. At the scheme level of a DC fund, on average 90% of members opt for the default fund.

It is important however to highlight that responsible investment can take a form of stewardship and ESG integration, which can and should be embedded into the mainstream funds. That is the approach we take at LGIM, rather than hard exclusions based on personal views.

As an example of how a mainstream fund can incorporate sustainability and responsible investment successfully, LGIM recently launched the Future World Fund. www.lgim.com/futurefunds

The fund was developed in collaboration with FTSE Russell and the HSBC pension scheme. The fund has been made HSBC's default fund (GBP 1.85bn). The fund targets better risk-adjusted equity returns than a traditional index strategy and it incorporates a climate 'tilt' to address the investment risks associated with climate change. It does this by reducing exposure to companies with worse-than-average carbon emissions and fossil fuel assets, while increasing exposure to those which are successfully generating revenue from the green transition. In addition, through the Climate Impact Pledge LGIM identifies some of the largest companies within the fund that are critical to the shift to a low-carbon economy. Through our research we rank them against criteria such as commitment to the low carbon transition, board composition, strategy and transparency. The result of such engagements is that some companies who fail to meet the minimum threshold will be divested out of the fund.

We anticipate greater uptake in this area of responsible investment moving forward, opposed to pure ethical funds.

We are also monitoring and anticipating developments driven by commitment to and uptake of the Sustainable Development Goals (SDGs) within investment strategy considerations. A greater focus on the SDGs by government in particular, as well as business and investors could facilitate broader engagement with the concept of impact investing, under the umbrella of which sit social investments

## c) What sort of returns do they provide?

Please find the historical returns from our range of responsible investment strategy:

| Name | Index | turn Ty | Ccy | Fund YTD - to 30.09.16 | BM YTD - to 30.09.16 | Fund 1 year to 30 Sep 16 | BM 1 year to 30 Sep 16 | Fund 3 Yrs- 30 Sep 16 (p.a.) | BM 3 Yrs- 30 Sep 16 (p.a.) | Fund 5 Yrs- 30 Sep 16 (p.a.) | BM 5 Yrs- 30 Sep 16 (p.a.) | Fund 10 Yrs- 30 Sep 16 (p.a.) | BM 10 Yrs- 30 Sep 16 (p.a.) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| FTSE All-Share ex Tob Equ Ind | FTSE All-Share ex Tobacco | Gross | GBP | 11.6 | 11.52 | 16.02 | 15.89 | | | | | | |
| Ethical UK Equity Index | FTSE4Good UK | Gross | GBP | 10.99 | 10.96 | 15.26 | 15.15 | 6.71 | 6.62 | 11.64 | 11.59 | 5.61 | 5.51 |
| Ethical Global Equity Index | FTSE AW - 4Good Global | Gross | GBP | 18.39 | 18.35 | 27.54 | 27.49 | 13.82 | 13.79 | 16.1 | 16.1 | 8.14 | 8.03 |
| Ethical Global Eqty Ind-GBPHgd | FTSE4Good Glbl Eq NetTax (UKPN)-GBP Hdg | Gross | GBP | 2.48 | 2.58 | 8.29 | 8.4 | 8.63 | 8.71 | | | | |
| FTSE World Dev ex Tobacco Indx | FTSE Dev ex Tobacco NetTax (UKPN) | Gross | GBP | 20.37 | 20.33 | 30.62 | 30.58 | | | | | | |
| FTSEWoDev exTobacco IndxGBPHdg | FTSE Dev ex Tobac NetTax (UKPN)-GBP Hdg | Gross | GBP | 3.75 | 3.76 | 10.1 | 10.11 | | | | | | |
| MSCI Wrld Low Carbon Trgt DesE | MSCI World Low Carbon Target | Gross | GBP | 20.37 | 20.26 | 30.74 | 30.62 | | | | | | |

Please note that the Future World Fund will start investments from February 2017.

## QUESTION 5: PENSION SAVER ENGAGEMENT

(Call for evidence, paragraph 1.18)

We seek views about how far these options (identified in Question 4) 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?

| Yes: | No: | Other:✓ |
|---|---|---|

**a) Would a greater range of options encourage greater engagement and pension saving?**

i) In general it is not the availability of funds that is the prime issue, rather the take up of funds. This low take-up could be attributed to a poor range of options; however a key issue that cannot be overlooked is the lack of member engagement with their pension; c.90% opt for the default fund. Weak engagement of members with their pension demands attention at the level of process and the level of education, in particular if pension funds/fund holders are to be encouraged into social investments.

Regardless of investment options, it is important that members are engaged with their scheme at the point of joining. This is not always best achieved through ticking boxes on HR joining forms or through an online platform that has had little explanation.

In terms of education, if members are to engage more with their pension they need to have a greater understanding of how their own capital is put to work, as well as the relationship between an individual's pension scheme choices and the issues they may be interested in at an economic, social and environmental level.

In general there appears to be a disconnect between the two. LGIM commissioned an online survey (carried out by FTI Consulting, pooling 1,681 people in October 2016). When asked the question 'how knowledgeable are you of the types of investments your savings are invested in by your pension managers', 53% of respondents answered 'I am not knowledgeable but I

would like to be'. 34% answered that they are knowledgeable and 13% that they are not knowledgeable and don't want to be. For more detail on the findings, please see 'further information' section.

In order to shift engagement and understanding we must move away from the current message that investment risk and social motivations sit at opposite ends of the spectrum and that one must be chosen at the expense of the other. This requires education across all pension stakeholders, including Trustees, investment consultants and fund managers. Lessons can be drawn from the likes of the Netherlands, Nordics, Canada and Australia who are recognised leaders in responsible investment. A first step in the process is to establish an agreed and definitive list of terminology that references the different types of investment strategies and how they help their money, as well as society at large. Without this it is difficult for various pension fund stakeholders to identify and match investment needs, expectations and interests in order to deliver or source appropriate product offerings.

Product innovation at the asset manager level is essential in order to ensure that appropriate options are available, but they have to be accompanied by education and communication that substantiate their individual claims.

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

We believe investment options that have the additional benefit of social impact could encourage engagement. But it has to be simple and accessible to members and capacity needs to be built in to accommodate a wide range of views and opinions.

LGIM's research (referenced above) supported the evidence found in the DC pension conference; that younger employees are keen to invest in a pension with a social purpose and that some may be prepared to do this even if the returns are lower. ('Identifying new ways to engage with savers in DC pensions', March 2013.)

Some of LGIM's own research further found that 81% of those surveyed either strongly agreed or slightly agreed that they would prefer their pension to be invested in responsible companies that will improve life for future generations. 64% considered it important to be given the option of investing in innovative companies working towards a better future for society, however only 37% had been given the option. 38% agreed that pension fund managers should not jeopardise returns based on responsible

| considerations; 42% slightly agreed. On average respondents were willing to sacrifice 3% per annum of returns to divest their pension from companies harming the climate (although there was a large variance in the answers and appetite for losing any performance). |
|---|

**QUESTION 6: RETURNS FOR SOCIAL INVESTMENT**

(Call for evidence, paragraph 1.18)

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?

| Yes: | No: | Other: ✓ |
|---|---|---|
| a) **Are there sufficient investment opportunities to provide both social impact and market returns?**<br><br>This depends on how social impact is defined and measured, as well as what asset classes and geographies are being considered. Availability and comparability of data on social impact, as well as a limited track record of social impact performance and financial return, are issues that might limit the selection of investment opportunities. Political risk, currency risk and illiquidity are other factors that could limit the availability of investment opportunities in social investments. These will be asset class and geography dependent.<br><br>Social impact definition and measurement: Having a broader, but clear and structured framework of definition for social impact **could enable access to a greater range of investment opportunities that provide market returns**.<br><br>A broader framework of definition could encourage the development of products that cater for varying degrees of member interest and engagement in social investments, and therefore in turn encourage greater engagement with pensions. Publically listed companies that demonstrate social impact through goods or services they produce could be considered for example, alongside infrastructure, private equity or venture capital etc.<br><br>In terms of available opportunities, the key issue for private equity and | | |

venture capital might rather be the availability of data and track record, rather than availability of investment opportunities. The risk return profile of infrastructure opportunities in emerging markets can be a limiting factor, while a lack of available investments in home markets can result in the crowding of capital into a limited number of investments. Overseas infrastructure investments must take greater account of political and currency risk.

In the traditional equity and credit space, the investment returns implications from being also socially focused have been thoroughly researched; with the conclusions that returns don't have to be compromised.

*Two meta academic studies of ESG and their links to the financial returns*

- ESG and financial performance: aggregated evidence from more than 2000 empirical studies
- From the stockholder to the stakeholder - how sustainability can drive financial outperformance

*Three other research/summaries from the investor side.*

- UBS - ESG Quant Investing
- Barclays - Sustainable investing and bond returns
- MSIC – Can ESG add alpha

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

The question is as much about returns as the timeframe of the assessment period. The importance of returns in the 30-40 year time frame is lacking from the investment dialogue today.

The narrative on social impact and returns needs to be reframed when applied to long-term pension fund investments. The appropriateness of traditional short-term measures to assess performance of such investments needs to be reconsidered. From the outset, the application of traditional measures is likely to reduce the pool of appropriate and therefore available investment opportunities. If short-term measures of assessment are applied the results could reinforce the idea that social impact requires return sacrifice, and this could reduce both interest in and allocation of capital to these investments. Any potential long-term performance, both social and financial will not then be realised.

Nonetheless, we have carried out research in this area. The results of the

focus groups revealed that respondents were willing to sacrifice on average 3% per annum of returns to divest their pension from companies harming the climate. On broader questions of responsible investment, 64% considered it important to be given the option of investing in innovative companies working towards a better future for society, however only 37% had been given the option.

Finally, investors need to consider the positive impact of ‘mission-led’ businesses within the broader context of contributing to a healthier economy, which could provide improved investment conditions over the long-term. This requires a fundamental re-think of the narrative around social investments and in particular, ethical investments.

## QUESTION 7: FINANCIAL ADVISORS AND SUITABILITY

(Call for evidence, paragraph 1.22)

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) **Best explore their clients' social motivations?**

Financial advisers' role should be emphatically defined to address the long-term investment requirements and return expectations of members.

Members should be offered face-to-face financial information and advice when joining the scheme.

Financial advisers, investment consultants and pension fund managers should be required to have a basic level of knowledge with regards responsible investment. They should be able to differentiate between a range of responsible investment strategies, and understand the potential return implications of each for a) the risk and performance profile of funds over different timeframes, and b) social and environmental impacts of the chosen fund on the society at large.

Moreover, there needs to be greater recognition and awareness among all pension stakeholders of the relationship between 'mission-led' businesses - or businesses providing positive social/environmental impact, and the broader economy and investment environment. The health of the economy, the environment and society are not mutually exclusive states – particularly over the long-term. Investment professionals and pension scheme members need to more readily consider these linkages. Businesses contributing to societal/environmental good, in turn are contributing to a healthier economy, which over time could provide a stronger investment environment.

Education and communication is therefore needed not only to illustrate that social impact investments don't necessarily require return sacrifice, but to demonstrate the potential indirect benefits of social investments to investors and returns more broadly. This could lead to greater engagement both of individuals with their pension and of investors with social investments.

As outlined in the recent report published by the Government's Advisory Panel on Mission-Led businesses, education systems, and particularly business and financial education systems have a role to play in creating a society that nurtures and demands mission-led businesses. This also applies to developing understanding and demand for social investments. As the report also outlines; "academics can build evidence for the long-term impact of socially responsible businesses, and challenge the idea that caring for society must come at the expense of profit."

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

It is important to move away from the current message that investment risk and social motivations sit at opposite ends of the spectrum and that one must be chosen at the expense of the other.

An improved knowledge base among financial advisers would enable them to more readily present social investment options in a way that is clear, fair and not misleading.

A definitive list of terminologies within the industry would assist this process. It would also potentially support greater product innovation and drive greater demand. This is because improved clarity on the subject would enable members to identify and match their interests to available products, and for pension fund managers to develop and target products more appropriately to a range of client interests and financial requirements.

**QUESTION 8: LABELLING SOCIAL INVESTMENT OPTIONS**

(Call for evidence, paragraph 1.23)

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?

| Yes: ✓ | No: | Other: |
|---|---|---|
| The most pressing step now is to create a definition of responsible investment in general, and a framework for understanding social investments | | |

and their varying risk/performance and impact implications.

Appropriate labelling could be useful, but it is not helpful in the current investment environment, as anything with a green/responsible label would be considered ethical and is therefore perceived to be an investment that will likely lose money/reduce returns.

As with green/climate bonds, a balance needs to be achieved between attracting scale and achieving perfect reporting with regards to impact. As the market for green/climate bonds has evolved over the last few years, there have been a number of debates around the question 'how green is green'? Some consider that a green bond should not be labelled as such unless proceeds are used for projects/businesses that fit very clear criteria of green, and that there is an effective process for monitoring and auditing use of proceeds. We understand this view and agree that it is important to maintain product credibility with regards to climate/green impact. However, for both green bonds and social investments, scale and liquidity in the market need to be encouraged if viable investment products are to be developed, and if capital is to be reallocated at scale. This requires a certain level of flexibility as the market develops and therefore requires a broad framework of different types of social investments to be defined.

**QUESTION 10: LAW OF SOCIAL ENTERPRISES**

(Call for evidence, paragraph 1.25)

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?

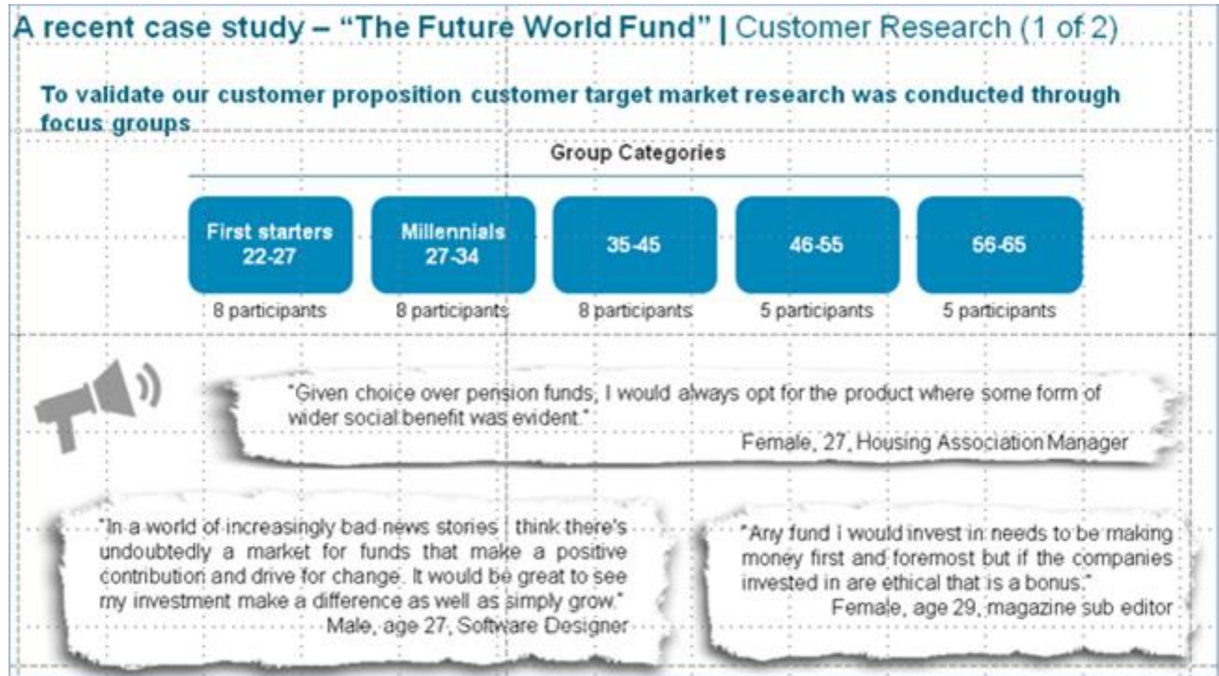
| Yes: | No: | Other:✓ |
|---|---|---|

We do not have particular expertise in this area. It seems appropriate to review the legal framework to consider other models that are evidenced to have worked elsewhere. However this would need to be alongside a broader analysis of social investments in France and the drivers behind a high level of uptake of such schemes, including an assessment of what is specifically contained in those schemes.

**FURTHER COMMENTS:**

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.

**We would like to share some further findings from our recent customer research, which was commissioned ahead of the launch of The Future World Fund.**




New and engaged ... Active and accumulating ... Focused on the end game

| 22 - 26 | 27 - 34 | 35 - 45 | 46 - 55 | 56 - 65 |
|---|---|---|---|---|
| Receptive to investing, seen as a 'normal' part of life and 'good practice' | Investing for their future and what it may bring | Accumulating but becoming more aware of risk and de-risking | Aware of dependents needs and investment goals | Focused on the figures, and the total pot |
| Mixed view towards taking risk – some speculative, others protective | Grasp of pension scheme and 'how it works' | Thinking about future of dependents | Risk conscious as trying to recoup losses from 2008 but still looking to accumulate | Not a time to take risks or suffer a big loss |
| Engaged as closest to 'point of entry' | Retirement seems a long way off - engagement is relatively low | More active, and engagement or 'ownership' increasing | Thinking about providing themselves with a few extras in retirement | Facing decisions about how to use pot to fund retirement |
| Open to messaging | Most are medium risk but some have ring fenced money to seek higher return with | Looking for added value | | 'What's done is done' attitude towards pension scheme investment |

Most are to some degree conscious of 'ethical' issues. A majority might reflect such principles in their investment choices.

- The pre group questionnaire reveals that the majority might reflect their awareness of such issues within their investments - around a sixth of respondents would be very keen to do so, however a sixth don't feel that it would feature in their investment decisions

Q. Thinking about how you make decisions about managing your investments or would intend to when the time comes, which of these statements best describes you?
(Base: All respondents (30) Figures in chart are numbers not percentages. Average score calculated by applying a score of 1 to 5 to each of the answer codes as shown on chart above)

- By age group, The oldest age group (56-65) are least swayed by environmental or social responsibility when making investment decisions, and 27-34s the most so.

- For several, thinking about such personal principles and investing together, hadn't been something which went 'hand in hand' or that they had given much consideration
    - On further thought, most could see that it was an appealing option to have or to provide to people as it could facilitate a 'feel good factor' or feeling of added benefit
    - That said, most agree that ultimate choice will be swayed by performance and returns – whilst this was a consensus across all groups it was most

prevalent in the older age groups, and was particularly so amongst 56 to 65 year olds
    - For one or two, there was quite a high degree of cynicism, mainly focussing on what little good it would do in the grand scheme of things
- Some direct quotes:
    - 22 – 26 year old: “It’s a good idea, but I’m more concerned at the moment with what will bring a solid return than using a fund that might be good for the environment - however if it will provide a solid return then that’s a big benefit”
    - 27 – 34 year old: “I’m really positive about it - but I tend to associate ethics and morals with low return”
    - 35 – 45 year old “I think that that could be interesting, it’s an interesting offering – but it would have to meet my investment needs too”
    - 46 – 55 year old:” It’s good, getting into ethical and green issues - as long as it makes money - I would be happy!”
    - 56 – 65 year old:” I invest to make money, I'm not really interested in saving the planet or things if I lose money - selfish but that’s the bottom line!”

➢ Some further details and attitudes towards ESG investing

**22 – 26**

- For those just starting out, whilst the ESG aspect is appealing, and promotes a feeling of 'doing your bit'
- They are conscious of ethics/green issues but had not associated these principles with investing – however they are not closed to it – rather they had just not thought about the two scenarios together
- They have concerns about returns (this group have the least amount to invest – on average >£5k)
- Most resonance is with the environmental aspects, although a few did mention 'companies doing the right thing'
- Most have further questions at this stage about how the companies are actually assessed

**27 - 34**

- The notion of ESG investing had a high level of appeal for this group, however concerns were noted over returns
- There was a general association with 'lower returns' and what they perceived this kind of investment could provide
- There was more resonance with the Environmental elements, a little with governance but the social aspect and example of 'fair pay' and 'health and safety' did little to pique interest
- For this group, there was a sense that this investment option might be for a long term investment such as a pension, the notion being that for higher returns, a shorter term investment focused purely on performance/returns would be preferred

**35 - 45**

- Firmly in the accumulating phase, they are generally active and pragmatic investors
- Some noted that they haven't seen ESG fund types appear much in their research ( e.g. in the HL Wealth 150)
- Their perception is of a niche / small cap style fund which may have good growth potential
- Despite regarding themselves as medium risk, this group appears to still be open to the prospects of both long term returns (as they still have some way to go before having to call upon their pension savings) and some shorter terms gains with smaller pots of money

**46 - 55**

- The notion has basic appeal but for this group, it all hinges on performance
- For some, the concept of having ESG investments is perceived to be a 'slow burner'
- There is a general notion of ESG being quite nice to have, but not essential

**56 - 65**

- Despite some liking the general idea, and agreeing that 'doing some good through something that you were doing anyway' is a positive – this group is the most focused on returns
- At the point of crystallizing pension pots, there is a reticence to 'rock the boat' and more focus on returns, income and performance in a more immediate time frame
- Not particularly interested in things with more than a 5 year investment horizon

**From:** Madeleine Pickett
**Sent:** 08 November 2016 10:19
**To:** LAWCOM Commercial & Common Law
**Subject:** Social investment/ pension schemes and the mentally ill. Would I be offered a social pension component top up to a state pension if ever I could work again, with support part time- with an employer environmentally aware/ charity environmentally aware/ ...
**Attachments:** pension_funds_call_for_evidence_Nov2016.pdf; ATT00001.txt

It would be nice if we weren't left out as some long term mentally ill, want to reach pensionable age and not be left out of any governments capitalistic lifestyle disabling our services on which we depend.

I am not a charity case and nor do I want work related tax payers suffering and discriminatory bodies I.e. Work capability assessing me, based on governmental floundering in the decision process of what and how the public ( which does include me) needs to better "our" little Britain., Why hasn't the benevolent funds and charities been able to help the vast number of "needy English"
?
Are we just monetary burden to a Tory gov.
?
Socially with a social pension I'd do better if, a big if for the long term unemployed We inc me, reach a pensionable age.

Do you use the law of averages when means testing, the impact of a failing NHS, with taxed workers moral at an all time low.

Their life is a vocational one.
Mine a deprived/ neglected one under this gov.

Social enterprise for the environment is key to all who still wish to breath in London or other cities, VW scandals included; you may surmise Buses are a social enterprise, given the hospital bugs and winter colds.

I still need them, in my area I live rurally and am not served.

So, how will the long term mentally ill, with a view to be included in politics but not the bed blocking scapegoats of all fiscal matters that pertain to a bigoted corrupt government?

I like how it looks on paper, we get it all, the reality is a stark contrast un-admitteable by the majority responsible; i.e. This gov...

Will social pension schemes be available to me, and will it see the disabled through a bad government?

Yours sincerely

Ms Madeleine Anna Pickett

P.s. I do want to know!

______________________________________________________________________
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For more information please visit http://www.symanteccloud.com
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Law
Commission
Reforming the law

**THE LAW COMMISSION**

**PENSION FUNDS AND SOCIAL INVESTMENT**

This optional response form is provided for consultees' convenience in responding to our call for evidence on pension funds and social investment.

The response form includes the text of the questions in the call for evidence, with boxes for yes / no answers (please delete as appropriate) and space for comments. You do not have to respond to every question. Comments are not limited in length (the box will expand, if necessary, as you type).

Each question gives a reference in brackets to the paragraph of the call for evidence at which the question is asked. Please consider the surrounding discussion before responding.

We invite responses from 7 November 2016 until **15 December 2016**.

Please return this form:

By email to: commercialandcommon@lawcommission.gsi.gov.uk.

By post to: Lucinda Cunningham, Commercial and Common Law Team,
Law Commission, 1st Floor Tower,
Post Point 1.53, 52 Queen Anne's
Gate, London SW1H 9AG

We are happy to accept responses in any form. However, we would prefer, if possible, to receive emails attaching this pre-prepared response form.

**Freedom of information statement**

Any information you give to us will be subject to the Freedom of Information Act 2000, which means that we must normally disclose it to those who ask for it.

If you wish your information to be confidential, please tell us why you regard the information as confidential. On a request for disclosure of the information, we will take full

account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not be regarded as binding on the Law Commission.

***The Law Commission processes personal data in accordance with the Data Protection Act 1998 and in most circumstances it will not be disclosed to third parties.***

**YOUR DETAILS**

| Name: | [redacted] |
|---|---|
| Organisation: | B&CE Ltd, provider of the People's Pension<br><br>The People's Pension is a master trust serving the auto-enrolment market. Master trusts are crucial to the delivery of auto-enrolment:<br><br>• To date, 124,487 employers have auto-enrolled their employees. 6,642,000 individuals have been auto-enrolled with opt out rates remaining below 10%. Over the next 2 years 1.4m companies will have to auto-enrol their staff into a pension. |

| | |
|---|---|
| | • The three largest auto-enrolment master trusts have a membership of over 6 million, which is the vast bulk of those auto-enrolled<br><br>The People's Pension is a master trust that provides pensions to any employer of any size and this mass market entry was not anticipated by previous governments. We provide low cost, high quality pensions to over 2.2 million low to moderate income earners.<br><br>The People's Pension is administered by B&CE, a not for profit organisation that has served the construction industry since 1942. It is an efficient third sector alternative to the government funded state intervention of NEST. It is not reliant on state subsidy of any kind. We are run under a trust in the interest of our members. We work with small employers, many of whom want to pay a modest fee for a tailor-made service so that they can concentrate on running their businesses. |

| Role: | [redacted] |
| --- | --- |
| Postal address: | [redacted] |
| Telephone: | [redacted] |
| Email: | [redacted] |

**CONFIDENTIALITY**

Do you wish to keep this response confidential?

| Yes: | No:X |
| --- | --- |
| If yes, please give reasons: | |

**QUESTION 1: BARRIERS TO PENSION FUND INVESTMENT**

(Call for evidence, paragraph 1.15)

What are the barriers to pension funds investing:

(a) In infrastructure generally?

(b) In socially significant infrastructure?

(c) In other forms of social investments?

(a) The barrier to the People's Pension ("TPP") investing directly in infrastructure is scale. We are a mass auto enrolment workplace pension provider catering primarily for low to medium earners. The recent birth of the programme and the gradual rises in contribution levels mean that the assets under management are currently relatively small but will begin to rise significantly after 2019. Our ultimate aim is to mirror the activities of the large Canadian retirement funds but the cost of the in-house specialist staff required can only be justified once the assets under management are much larger. The Law Commission paper suggests that the price cap might be the driver for mass auto enrolment schemes using passive rather than active investment models. This is incorrect. The drivers are two other factors. First, active investment models in general, although not in specialist investment fields such as infrastructure, do not deliver any value to savers. Second, all of the large master trusts price at levels well below the price cap in any event and this is necessarily the case because high scheme charges can absorb a significant proportion of an individual's potential retirement savings.

A future serious long term threat to the ability of pension schemes to invest in

illiquid investments arises from the lack of joined up thinking in government policy. By encouraging people under 40 to invest in the Lifetime ISA and to divert pension saving to house purchases, the government will force pension schemes to avoid illiquid investments to the detriment both of potential infrastructure investment and to the detriment of a younger generation's future pension savings. In aggregate, the consequence of the Lifetime ISA will be an even greater diversion of national wealth into existing national housing stock.

Other elements of the pension freedoms agenda also place an emphasis on liquidity and this also militates against investment in less liquid and higher returning assets.

(b) The selection criteria for TPP trustees when choosing a fund manager include their environmental, social and governance ("ESG") policies. However, at the current time, the offer from large low cost passive funds does not include a component labelled as national socially significant infrastructure. At this point in the development of mass automatic enrolment workplace schemes, policy would have to be directed at encouraging large fund managers to direct investment into socially significant investment.

(c ) Large scale social investment would require that policy encouraged fund managers to offer passive funds that included a social investment element. At a much smaller scale we can and do engage in charitable activity through the B&CE

| Trust. |
| --- |
| |

**QUESTION 2: LEGAL AND REGULATORY BARRIERS**

(Call for evidence, paragraph 1.15)

Do any of those barriers (identified in Question 1) relate to issues of law and regulation?

| Yes: Yes | No: | Other: |
| --- | --- | --- |

| | | |
|---|---|---|
| | (a) | The UK workplace pension market is currently fragmented into an enormous number of single workplace schemes. Measures to promote consolidation of pension schemes will increase the ability of consolidated schemes to invest in infrastructure. |
| | (b) | The law creating the Lifetime ISA and providing a government subsidy for the product will create a barrier to long term investment. |

**QUESTION 3: SIZE OF PENSION FUNDS**

(Call for evidence, paragraph 1.15)

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

| Yes: Yes | No: | Other: |
|---|---|---|
| The main legal obstacle to the merger of master trusts is the requirement for | | |

an actuarial certificate. A requirement inherited from the defined benefit regime but which makes little sense with respect to defined contribution schemes and provides no consumer protection in the latter situation. Provisions in the draft Pension Schemes Bill will allow the Secretary of State to lift this obligation in the limited circumstances of a scheme winding up. However, in order to facilitate consolidation, this provision should be more widely disapplied.

**QUESTION 4: ETHICAL PENSION OPTIONS**

(Call for evidence, paragraph 1.18)

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?

(a) We provide the B&CE Ethical fund. The factsheet can be found here: https://thepeoplespension.co.uk/wp-content/uploads/2015/11/bandce-ethical-fund.pdf. The vast majority of ethical DC funds apply a negative screen to a chosen equity index.

(b) 0.21% of members have opted for the Ethical fund.

(c ) The return over three years has been 46.15%. Returns can be more volatile than the index as a whole due to the screening, leading to wider dispersion in returns.

**QUESTION 5: PENSION SAVER ENGAGEMENT**

(Call for evidence, paragraph 1.18)

We seek views about how far these options (identified in Question 4) 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?

| Yes: | No: | Other: See below |
|---|---|---|

(a) This would depend on the time frame adopted. Auto-enrolment is a semi-obligatory inertia-based programme. It was adopted because the bulk of the population were and are disengaged from pension saving for a host of well researched behavioural reasons. In the short to medium run, no mechanism or policy is realistically going to overturn these psychological biases, except in a small number of cases. Almost all savers into automatic enrolment go into the default fund because they have exercised no choice. (It should be noted in this regard that this is only slightly more extreme than in historic pension schemes for higher earners where typically around 90% of members, often faced with up to 150 fund choices, failed to exercise any choice and were placed in the default fund). All the evidence points to a greater range of options having either no or extremely limited effect on

engagement with pension saving. It is well-established in behavioural economics that choice beyond a certain level leads to paralysis in decision-making. It may be that when the size of people's pots become much larger that it might become feasible to engage a somewhat larger minority. Currently, the average total pot of one of our members is £675. Given that this response may seem less optimistic than the Commission might hope for, it is worth noting that we have no vested interest in the disengagement of our members. Rather the contrary, we are constantly seeking mechanisms to engage with our members and we provide what has been recently recognised as the best customer service operation in the UK. It is in their interest, and ours as an economic actor, that they save more into their pension scheme.

(b) Only in a small number of atypical cases.

(c) What these answers point to is that any policy intervention that was based on promoting consumer demand is highly unlikely to have much impact and the government would have to look instead to supply side policies.

**QUESTION 6: RETURNS FOR SOCIAL INVESTMENT**

(Call for evidence, paragraph 1.18)

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?

| Yes: | No: | Other: |
|---|---|---|
| (a) For a mass workplace scheme, the low cost funds available to us on the market do not have the kind of "social impact" metrics the consultation document appears to be suggesting. However, the term "social impact" appears to be very vaguely defined category and refer to a potential a priori list of investments rather than any measure of overall social welfare. It may be that the ESG criteria applied by fund managers already allow them to generate greater social welfare and it is more efficient for the state to tax these funded activities and for the state itself to then fund lower returning or unprofitable activities with a social value. | | |

(b) Automatic enrolment workplace pensions will likely assist most of their members to obtain an annual revenue equivalent to 15% of their workplace income. In combination with the state pension, this may get them to a 50% replacement rate. The vast majority will not elect to make any choice with regard to a fund and will go into the default. Given their prospective income, it would be particularly inappropriate for the workplace pension provider to have a default that did not prioritise returns for them. If we offered a fund that sacrificed return for social impact, very few would actively make any choice. We would be obliged to point out the income consequences for any that did so. The likely consequence is that even fewer would then adopt it.

**QUESTION 7: FINANCIAL ADVISORS AND SUITABILITY**

(Call for evidence, paragraph 1.22)

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) For a mass scheme, the best mechanism will be in-depth focus groups which seek to reveal the actual likely responses to proposed products rather than generic polling.

(b) Any investment option that is not presented in those terms would breach the trustees' duties to members and also fall foul of consumer protection legislation.

**QUESTION 8: LABELLING SOCIAL INVESTMENT OPTIONS**

(Call for evidence, paragraph 1.23)

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?

| Yes: | No: | Other: |
|---|---|---|
| If fund managers are to offer products to pension schemes which include social investment options some form of standardisation would be necessary to make this an efficient process. | | |

**QUESTION 10: LAW OF SOCIAL ENTERPRISES**

(Call for evidence, paragraph 1.25)

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?

| Yes: | No: | Other: |
| --- | --- | --- |
| | | |

**FURTHER COMMENTS:**

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.

| |
| --- |
| |

PENSIONS AND
LIFETIME SAVINGS
ASSOCIATION

15 December 2016

Lucinda Cunningham
Commercial and Common Law team
Law Commission
1st Floor Tower
52 Queen Anne's Gate
London
SW1H 9AG

Dear Lucinda

## LAW COMMISSION CALL FOR EVIDENCE ON PENSION FUNDS AND SOCIAL INVESTMENT

I am writing in response to the Law Commission's call for evidence on social investment, on behalf of the Pensions and Lifetime Savings Association (PLSA)

As the trade body for over 1,300 pension schemes with around £1 trillion worth of assets under management and over 20 million members, the PLSA is supportive of the concept of social investment. Pension funds are long-term investors with time horizons that extend over decades, so making sustainable investments with enduring social legitimacy is critically important to our members. We believe that understanding and improving the social and environmental impact of DC pension schemes' default funds is the likeliest way to achieve better social outcomes from DC investments

**Scale**

The PLSA helped establish the Pensions Infrastructure Platform (PiP) in order to enable smaller pension funds to achieve the scale necessary to access infrastructure investment opportunities – as the Law Commission's 'call for evidence' notes, size is a key barrier to pension funds' capacity to invest in major infrastructure projects, which can require several billion pounds worth of funding.

The interim report of the FCA's Asset Management Market Study found that nearly 33,000 trust-based defined contribution pension schemes have 11 or fewer members. A further 2,300 schemes have fewer than 1,000 members. Only 120 schemes have over 5,000 members. Therefore, many pension savers are invested in schemes that are unable to generate the

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Pensions and Lifetime Savings Association is the trading name of the National Association of Pension Funds Ltd, a company registered in England and Wales with company number 1130269.
Registered office: Cheapside House, 138 Cheapside, London, EC2V 6AE

resources – both in terms of finance and expertise – necessary to invest in infrastructure projects or specialist social investments. The PiP offers a means of overcoming this obstacle. Consolidation of smaller schemes into larger entities would also increase the feasibility of infrastructure and social investment projects for pension funds. Scale matters as there is an association between scale and investment performance in DB schemes that we think will hold for DC also once those schemes achieve sufficient scale . Access to alternative asset classes seems to be important in allowing larger schemes to achieve better returns.

Alongside this proliferation of smaller schemes, automatic enrolment is already building very large master trust pension schemes. For master trusts, the ratio of members to assets under management is not presently conducive to direct investment in infrastructure. For some schemes with large numbers of members but this situation will evolve as contributions rise and the schemes mature. We would anticipate well-run schemes looking to diversify their asset management organically as they grow.

**Engagement**

The main appeal of infrastructure investments to pension schemes is as a secure source of returns over the long-term. This provides a good match to the shape of the pension scheme liabilities, which are over many decades. Pension funds are also mindful of the space within their fiduciary duties to invest in accordance with the beliefs and values of the beneficiaries and to contribute, through their investments, towards positive outcomes including a fair, inclusive and sustainable society for those beneficiaries to retire into.

Research suggests that many savers are favourable towards the principle of social investment. The Law Commission consultation notes that over one million French citizens are invested in the 'solidarity funds' that designate 10 per cent of assets for social investment. When the PLSA conducted surveys asking pension savers about their priorities for the companies in which their pension savings are invested, financial performance unsurprisingly was the most important factor, but for those aged 18-34, this was level with the pay and condition of employees. Human rights and impact on the environment were also key considerations for a significant number of respondents.

Similarly, polling by IPSOS Mori found that 42 per cent of respondents either somewhat agreed or strongly agreed with the statement 'I would actively avoid investing in a company or industry which conflicted with my own ethical views, even if it offered superior investment performance.' There is, however, some discrepancy between these abstract responses to survey and savings habits as observed in practice.

The PLSA annual survey found that, on average, 92 per cent of DC savers remain in their default fund. This suggests a clear need for research designed to better understand the social and environmental risks and impacts of typical default fund investments. The PLSA has

15 December 2016

commissioned the Sustainalytics consultancy to undertake research to this effect, to be published in early 2016. We'd be very happy to meet with the Law Commission to discuss our findings in more detail.

Similarly, financial advisers quoted in a recent FT Adviser article on a survey suggesting that millennial investors were more interested in ESG issues than older counterparts were sceptical of the finding, stating that 'surveys have fairly consistently shown that many investors are well disposed to the concept of responsible investing, but this has never really translated into actual fund flows' and 'a survey is one thing but in the real world we just do not see this.'

This disconnect between stated preference or intention and actual behaviour is common across almost all areas of pension policy. It is possible, with a lot of effort, for an engaged employer to get employees to take decisions about their pensions. For example, tools now exist that make it easier for people to engage with and then take decisions about the level of their pension contribution. But, more commonly, people say one thing to researchers and then follow the line of least resistance. This is something that pensions providers and policy makers have to find ways of working around.

In general, people struggle to take good quality investment decisions. This is probably for three reasons. First, investment requires people to make judgements about an uncertain future. Second, human judgement is susceptible to a broad range of common biases and decision making short cuts that compromise our ability to evaluate probability and risk. Third, the level of technical knowledge required to exercise good judgement is in excess of that possessed by the average person.

There is a rich and engaging literature showing the extent to which people tend to lose money or otherwise compromise their financial wellbeing through poor investment decisions. Even those with elite educations may be prone to common and very basic errors in judgement.

**Potential reforms**

For those reasons, those tasked with making policy and running schemes need to think carefully about what their objective is when they encourage engagement with pensions and whether they can get there through another route.

The suggestion posed in the Law Commission call-for-evidence of a standardisation of social investments would be one way of promoting social investment and would make the area much easier for savers to negotiate. However, such an undertaking would be fraught with difficulties. Who would be the appropriate body to define social investment, and how would they do so, given that both the positive and negative impacts of any investment portfolio are likely to be highly subjective?

Although the two options are not mutually exclusive, a focus on the standards of default funds in relation to their social/ethical impact might be more productive than trying to persuade savers to explore options beyond the default fund.

The Law Commission's consultation will be useful in this respect, and we look forward to seeing the evidence gathered as part of the process and engaging with your ongoing work in this area.

Yours sincerely

**Luke Hildyard**
**Policy Lead: Stewardship and Corporate Governance**
**Pensions and Lifetime Savings Association**

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**THE LAW COMMISSION**

**PENSION FUNDS AND SOCIAL INVESTMENT**

This optional response form is provided for consultees' convenience in responding to our call for evidence on pension funds and social investment.

The response form includes the text of the questions in the call for evidence, with boxes for yes / no answers (please delete as appropriate) and space for comments. You do not have to respond to every question. Comments are not limited in length (the box will expand, if necessary, as you type).

Each question gives a reference in brackets to the paragraph of the call for evidence at which the question is asked. Please consider the surrounding discussion before responding.

We invite responses from 7 November 2016 until **15 December 2016**.

Please return this form:

By email to: commercialandcommon@lawcommission.gsi.gov.uk.

By post to: Lucinda Cunningham, Commercial and Common Law Team,
Law Commission, 1st Floor Tower,
Post Point 1.53, 52 Queen Anne's
Gate, London SW1H 9AG

We are happy to accept responses in any form. However, we would prefer, if possible, to receive emails attaching this pre-prepared response form.

**Freedom of information statement**

Any information you give to us will be subject to the Freedom of Information Act 2000, which means that we must normally disclose it to those who ask for it.

If you wish your information to be confidential, please tell us why you regard the information as confidential. On a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not be regarded as binding on the Law Commission.

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## YOUR DETAILS

| Name: | [redacted] |
|---|---|
| Organisation: | Schroder Investment Management Ltd |
| Role: | [redacted] |
| Postal address: | [redacted] |
| Telephone: | [redacted] |
| Email: | [redacted] |

## CONFIDENTIALITY

Do you wish to keep this response confidential?

| Yes: | No:✓ |
|---|---|

If yes, please give reasons:

**QUESTION 1: BARRIERS TO PENSION FUND INVESTMENT**

(Call for evidence, paragraph 1.15)

What are the barriers to pension funds investing:

(a) In infrastructure generally?

(b) In socially significant infrastructure?

(c) In other forms of social investments?

**(a) In infrastructure generally.** The UK DC market currently has a relatively low allocation to alternative assets, to which we include infrastructure, against international peers. The major barrier to investment arises because they are largely private market investments. These do not sit well with the current practice in the UK of having daily liquidity and pricing on DC pots. It may be necessary to consider monthly liquidity, which could have the added benefit of making other alternative assets attractive for these schemes.

**(b) In socially significant infrastructure**. Our research into DC Pensions has identified low cost as a key contributor to success. In our experience the costs around impact investments are relatively high which reflect the scale and additional governance needed. This may be a barrier for trustees looking to maximise returns for beneficiaries.

Our research (http://www.schroders.co.uk/en/ca/asset-management/thought-leadership/pensions/lessons-learned-in-dc-from-around-the-world/) has demonstrated the importance of timing at different stages of a DC's products life. During the growth phase we suggest the targeting of real returns and downside risk tools to reduce significant losses when the DC account is large. It would be important to consider how any socially significant infrastructure would fit in with a lifecycle investment strategy, in particular as some of these assets may be difficult to liquidate or hedge against.

We have discussed issues around supply in section 6. We also consider this

to be an issue.

**(c) In other forms of social investments** One of the major barriers is that "social investment" does not have a clear definition. In its purest interpretation it is a private market investment that aims to create a social as well as a financial return, sometimes known as impact investment. The term "impact investing" was coined in 2007 and is defined by the Global Impact Investing Network (GIIN) as: "investments made into companies, organisations, and funds with the intention to generate measurable social and environmental impact alongside a financial return." It could thus be applied to a range of investment styles, asset classes, sectors and geographies.

For example at Schroders we have developed tools that enable us to measure the social value of a listed security fund. This seeks to capitalise externalities such as carbon emissions and tobacco related health costs, offsetting them by positive factors such as investment in human capital or community donations. It is possible to use this reporting tool as an input into an investment process, and design a product that seeks to add social value in absolute terms or against a benchmark. The resulting product would be liquid and lower cost than a traditional impact solution.

A widening of the definition may mean that it is not only equity type investments that are deemed to be social. Peer to peer lending on targeted platforms or lending to borrowers such as Housing Associations could also sit within a fixed income allocation of a DC fund. This type of activity may have less associated risk than a pure impact investment, and might therefore be more attractive for trustees.

**QUESTION 2: LEGAL AND REGULATORY BARRIERS**

(Call for evidence, paragraph 1.15)

Do any of those barriers (identified in Question 1) relate to issues of law and regulation?

| Yes: | No: | Other: |
|---|---|---|
| | | |

We find the current Law Commission's guidance in "Fiduciary Duties of Investment Intermediaries" issued in July 2014 that trustees should take into account factors which are financially material to the performance of an investment, helpful. For the past 19 years we have been focusing our efforts on ESG integration and engagement across asset classes and geographies with the aim of improving investment outcomes for our clients. We firmly believe that companies with robust ESG performance are more likely to deliver superior returns over time. Increasingly clients are becoming more interested in our activities in this area seeking to better evidence and understanding of the impact that integration and Stewardship can have.

The Law Commission also concluded that, while the pursuit of a financial return should be the predominant concern of pension trustees, the law is sufficiently flexible to allow other, non-financial, concerns to be taken into account provided trustees have good reason to think that scheme members share their view, and there is no risk of significant financial detriment to the fund. Having examined these issues we are not convinced that the current guidance would provide Trustees with the right framework for evaluating these opportunities.

**Views of scheme members** In 2013 we published a paper entitled Lessons Learn in DC around the World (attached). We noted that DC members do not typically engage with their pension arrangements until they get close to retirement. Few even change their contribution rate and most opt for default funds. This creates a substantial difficulty for Trustees seeking to establish if social concerns are shared by DC beneficiaries.

**Risk of significant financial detriment** We have been examining impact investments in a variety of markets in some depth. The case studies on individual projects and the returns generated are encouraging. We have also reviewed academic literature on the topic. However we would caution that the sample size of the research into impact investments is still relatively small, especially compared to studies on other investments. It is therefore difficult to state with confidence that investing in these type of private market assets would not have a "risk of significant financial detriment to the fund."

We believe that these types of investment should be considered as an alternative asset class and therefore given the same care and attention that trustees apply to other asset classes. This would also mean that when taking professional advice (as Trustees are bound to do) their advisers would be obliged to cover social investment.

Unless given additional legal protection, trustees may be reluctant to add these types of investments to DC platforms. There are currently some 'safe harbour' funds that can be offered via a DC scheme's auto-enrolment default. If the 'investment risk' barrier to social investment is too difficult to overcome then social investment funds could perhaps be added to the 'safe harbour' options to give the Trustees comfort when selecting these

funds.

It is our view that a regulatory framework should be created that means that social investment can be taken into account by DC schemes. It is not an issue that is properly considered by DC schemes currently.

**QUESTION 3: SIZE OF PENSION FUNDS**

(Call for evidence, paragraph 1.15)

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

| Yes: | No: | Other: |
|---|---|---|
| | | |

**QUESTION 4: ETHICAL PENSION OPTIONS**

(Call for evidence, paragraph 1.18)

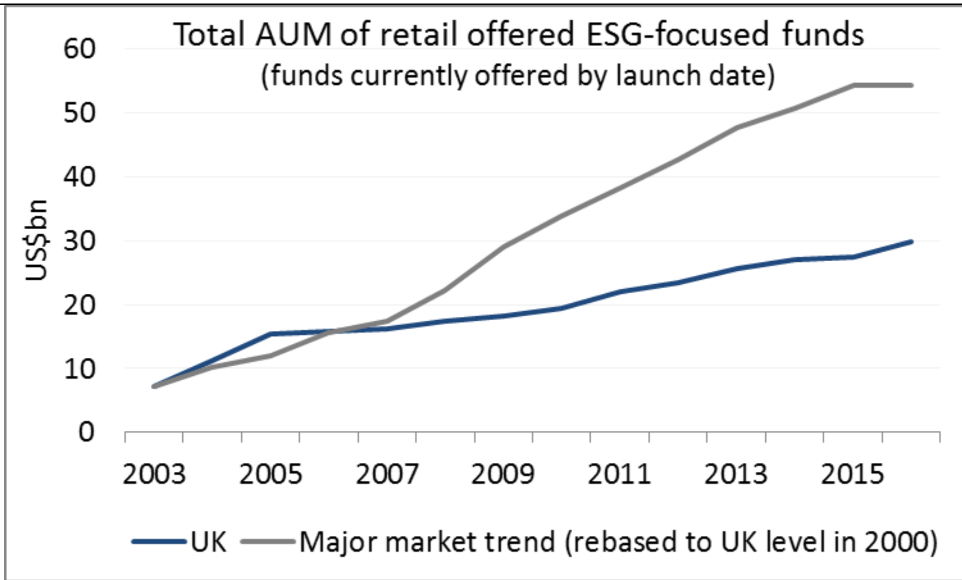
We wish to hear from employers and pension providers about the ethical options currently on offer (whether positively or negatively screened):

(a) What ethical DC pension funds are available?

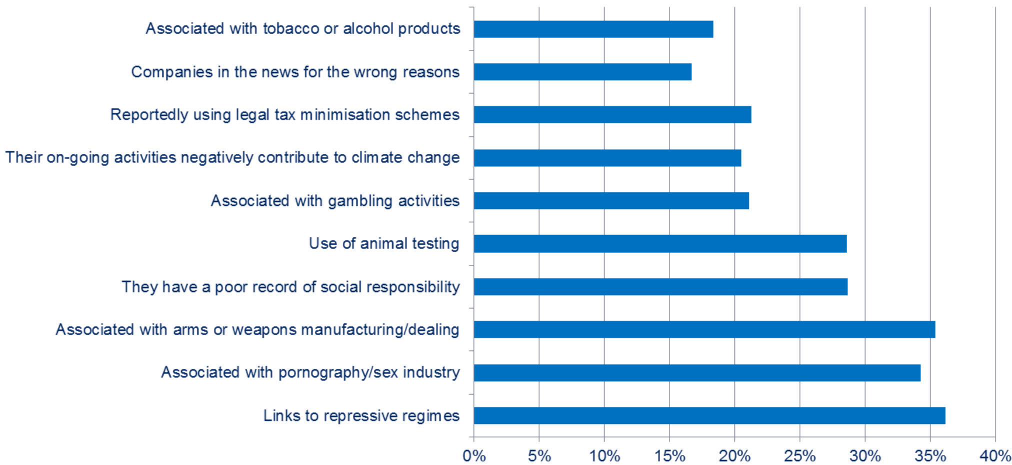
(b) What proportion of people take them up?

(c) What sort of returns do they provide?

(b) The UK Intermediary market AUM in ESG funds has had muted growth, especially against other countries. It has made up a steady 1% of AUM, with an increasing number of offerings.




This is despite our recent polling revealing a good interest in ethical issues from UK consumers.




Source: Schroders Global Investor Survey (2016) - Global Consumers.

Part of the issue has been performance many of the funds on offer have heavy ethical exclusions, or a narrow environmental focus. This means that they have a narrow opportunity set, leading to volatile performance. It indicates while some investors are

| focused ethical issues, this does not come at the expense of investment performance |
|---|

## QUESTION 5: PENSION SAVER ENGAGEMENT

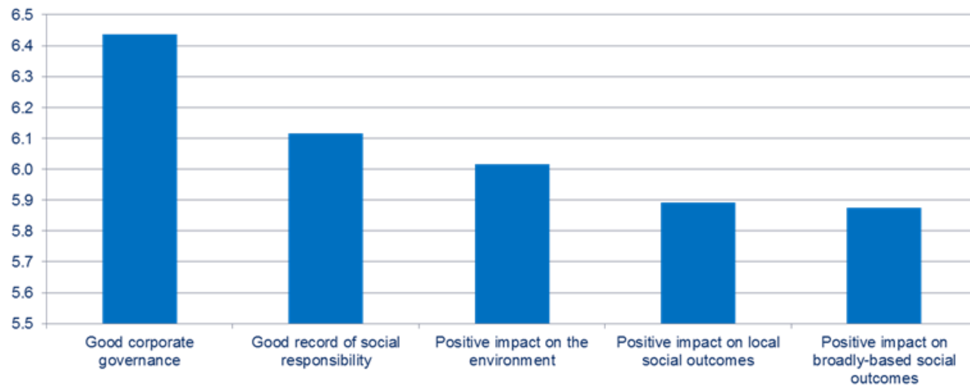
(Call for evidence, paragraph 1.18)

We seek views about how far these options (identified in Question 4) meet the needs of savers:

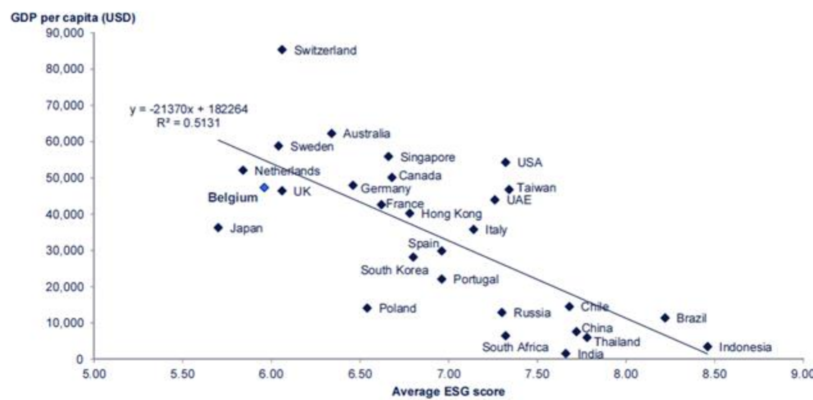
(a) Would a greater range of options encourage greater engagement with pension saving?

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

<table>
<tr><td>Yes:</td><td>No:</td><td>Other:</td></tr>
<tr><td colspan="3">Low levels of engagement echoes that feedback that we have had from Trustees when providing training on Environmental, Social or Governance issues (ESG). They receive few incoming queries on these topics. Most of the queries have arisen from campaigns supported by NGOs.<br><br>Our polling of investors reveals more interest in ESG related topics, including social investment, than current engagement levels indicate. The chart below show interest in the following issues out of 10 for the UK investors. Younger investors were consistently more interested in these issues than older investors, and they are an increasingly important cohort in DC pensions.</td></tr>
</table>




However we would note that in the UK investor engagement in ESG issues was relatively low against other countries.




To get traction social investment needs to be embedded into default funds as part of the scheme's overall strategy. Allowing members to select social investments via a self-select option will have no impact as the vast majority of DC funds are invested in the default.

## QUESTION 6: RETURNS FOR SOCIAL INVESTMENT

(Call for evidence, paragraph 1.18)

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?

| Yes: | No: | Other: |
|---|---|---|
| (a) From talking to a number of players operating in this space we have concerns that pure social investment opportunities are at present limited. Sourcing deals can be difficult and take time. Indeed many working in the industry say at present finding appropriate projects is far more difficult than finding committed money. This is not made any easier by the fact that thus far projects have been small and hard to scale. Many of the projects are in relatively niche areas and currently public agencies are more likely to establish their own efforts in more mainstream areas. | | |

**QUESTION 7: FINANCIAL ADVISORS AND SUITABILITY**

(Call for evidence, paragraph 1.22)

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?

| |
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**QUESTION 8: LABELLING SOCIAL INVESTMENT OPTIONS**

(Call for evidence, paragraph 1.23)

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?

| Yes: | No: | Other: |
|---|---|---|
| Please see our answer to 1c.<br><br>All of the approaches that we have outlined in our response carry with them different characteristics on risk, reward, cost, liquidity and scalability. We would suggest that a framework and standard definitions be developed around this that can be easily understood by beneficiaries. | | |

**QUESTION 10: LAW OF SOCIAL ENTERPRISES**

(Call for evidence, paragraph 1.25)

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?

| Yes: | No: | Other: |
|---|---|---|
| | | |

**FURTHER COMMENTS:**

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.

| |
|---|
| At an EU level an initiative by the Commission in 2011 resulted in the introduction of a regime for EU badged social investment funds in 2014– see link. A public consultation on why the take up of these funds was limited |

closed in January this year. The Law Commission might consider it useful to consider the responses received to the consultation in terms of its considerations of social investment.

http://ec.europa.eu/finance/consultations/2015/venture-capital-funds/index_en.htm

**THE LAW COMMISSION**

**PENSION FUNDS AND SOCIAL INVESTMENT**

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|---|
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**YOUR DETAILS**

| Name: | |
|---|---|
| Organisation: | ShareAction |
| Role: | |
| Postal address: | |
| Telephone: | |
| Email: | |

**CONFIDENTIALITY**

Do you wish to keep this response confidential?

| Yes: | No: No |
|---|---|
| If yes, please give reasons: | |

## QUESTION 1: BARRIERS TO PENSION FUND INVESTMENT

(Call for evidence, paragraph 1.15)

What are the barriers to pension funds investing:

(a) In infrastructure generally?

(b) In socially significant infrastructure?

(c) In other forms of social investments?

a) There are no legal or regulatory barriers to DB pension funds investing in infrastructure that we are aware of, and many larger schemes do make such investments. Smaller DB schemes face barriers relating to their expertise, the advice they receive and the fees they may be charged.

For DC schemes, the focus on daily liquidity is, in practice a significant inhibitor to infrastructure investment and to investment in other illiquid investments/asset classes.

b) For DB pension schemes 'socially significant infrastructure' would need to pass the Law Commission's two part test (i.e. that (1) trustees must have good reason to think that scheme members would share the concern; and (2) the decision should not involve a risk of significant financial detriment to the fund) if there were any question of a trade-off between financial return and social benefit (i.e. non-financial benefit).

For DC schemes the liquidity points above would also apply. If a member of a DC scheme were to make an active choice to invest in a fund with socially significant infrastructure (assuming the liquidity issues had somehow been overcome), that would allow for a trade-off between returns and social impact. For the default fund of a DC scheme, we believe the Law Commission's two part test is applicable.

## QUESTION 2: LEGAL AND REGULATORY BARRIERS

(Call for evidence, paragraph 1.15)

Do any of those barriers (identified in Question 1) relate to issues of law and regulation?

| Yes: YES | No: | Other: |
|---|---|---|
| | | |

## QUESTION 3: SIZE OF PENSION FUNDS

(Call for evidence, paragraph 1.15)

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

| Yes: Yes | No: | Other: |
|---|---|---|
| Small pension funds struggle to invest in infrastructure indeed in any non-core asset classes. They tend to lack the necessary trustee knowledge, staff skills (e.g. to undertake due diligence), and are even more reliant than large schemes on the advice of investment consultants. Many investment consultants see little advantage in proposing new ideas unless specifically asked to by clients.<br><br>In addition, small schemes tend to have less bargaining power when it comes to fees for investment management as they have less capital to bring to the table. Fees for illiquid asset classes are often high and particularly so for small schemes.<br><br>ShareAction has recommended to the government in our report, Realigning Interests; Reducing Regulation, that it takes steps to reduce the number of UK pension schemes in the best interests of scheme members. | | |

## QUESTION 4: ETHICAL PENSION OPTIONS

(Call for evidence, paragraph 1.18)

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?

As an employer, ShareAction uses Nest as an auto-enrolment provider and the quality of its ethical option weighed in our choice of AE provider. A number of our staff are using it.

We are due to undertake a more comprehensive review of ethical options available in the market shortly and will be happy to share this with the Law Commission in the New Year.

As far as we are aware very small percentages of employees (frequently less than 2%) opt to take these options up where they are on offer.

Returns vary considerably, and over short periods can come out both higher and lower than non-ethical funds depending on the level of screening and on the asset class composition. In some cases ethical funds have a less balanced asset class mix than non-ethical funds, driving volatility in returns. Screening within the equity component of ethical funds can also drive some modest additional volatility. The design of ethical pension fund options appears to have improved somewhat in recent years, notably by providing a more suitable mix of asset classes that compares well with the balanced approach adopted for non-ethical funds. Risk and return are largely driven by asset class decisions rather than by the level of screening in any given asset class such as equities.

We believe pension providers and employers should make ethical options available. The ‘ethics’ should be those of the fund members concerned and effort should be expended surveying and engaging members to establish their ethical concerns and how these can be accommodated with the minimum achievable trade off against expected long-term financial performance. With sufficient effort, we believe it is possible for ethical funds to achieve virtually identical long-term returns as those achieved in non-ethical funds, whilst supporting members in having their ethics (and other non-financial interests) acknowledged.

We note with interest the new DC default fund of the HSBC pension scheme, which has 80,000 members. The trustees made the decision to screen out of the default fund makers of controversial weapons, illustrating an application of the Law Commission’s two part test. This is, sadly, a very rare example of pension trustees

| seeking to accommodate members' ethical concerns. In addition, the Future World Fund used by HSBC as its DC default option has a more than usually active stewardship approach with respect to climate change risks in the equity portfolio. The primary motivation here is managing the financial risk to members caused by investee companies being poorly positioned as the global economy decarbonises. Nevertheless, many members of the scheme may also have ethical concerns about 'carbon pollution' and younger members may derive quality of life benefits over the long term from the avoidance of runaway climate change. Thus the scheme's stewardship approach has the benefit of satisfying those ethical and quality of life interests as well as members' financial interests. We very much like this approach.<br><br>Members' ethical concerns and prioritites can, often, be addressed through stewardship of investee companies (e.g. using voting and dialogue) rather than through screening out companies or sectors of the economy. |
|---|

**QUESTION 5: PENSION SAVER ENGAGEMENT**

(Call for evidence, paragraph 1.18)

We seek views about how far these options (identified in Question 4) 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?

| Yes: | No: No | Other: |
|---|---|---|
| a) There is no evidence we are aware of that a greater range of options would encourage engagement with pension saving. The academic evidence seems to suggest the opposite. The phenomenon is known as "choice overload".<br><br>There is evidence that a significant proportion of pension savers want to invest in things that create a financial return without "causing harm to our future". A NAPF (as was) survey from June 2014 found that 70% of UK | | |

adults surveyed 'felt it was important for pension providers to invest in companies that concentrate on avoiding unethical practices' and 49% of those surveyed would like their employer to 'choose a provider which makes a specific point of investing ethically, even if this fund would achieve lower returns on investment'. These survey results do not in practice translate into people choosing ethical options in DC schemes and it seems likely the same would broadly hold true if more social pension options were available. In our view, a range of measures aimed at making pension savers feel more empowered and supported in choosing options other than the default are necessary if the low take up of ethical and/or social investment options is to change. In the experience of savers ShareAction is in touch with, providers often do not make it particularly easy to opt out of the default.

b) It seems unlikely that making available investment options that aim to deliver social impact (as opposed to options branded 'ethical') would drive up engagement except if accompanied by other measures designed to make people feel more comfortable about departing from the 'default'.

ShareAction has written extensively about the steps pension schemes could take to engender a greater sense of ownership and agency amongst pension savers. In 2014 we published Our Money, Our Business, a short report setting out both the rationale and the mechanisms that might be adopted to bring savers and their concerns closer to the process of decision-making. We have never sought to undermine trustees' discretion but do believe that, in the context of pension investing (as opposed to private family trusts, for example) the voice of the beneficiary is a legitimate factor for trustees to weigh in their decisions.

We believe that encouraging and enabling pension savers to have their say and ensuring they feel heard could play a useful part in building a 'culture of saving' in the UK and restoring public trust in the pensions sector.

## QUESTION 6: RETURNS FOR SOCIAL INVESTMENT

(Call for evidence, paragraph 1.18)

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?

| Yes: | No: | Other: |
|---|---|---|
| a) We are not sufficiently expert in the social investment market to be able to give a useful answer to this question.<br><br>b) See below for a more detailed explanation of our thinking on non-financial factors. | | |

**QUESTION 7: FINANCIAL ADVISORS AND SUITABILITY**

(Call for evidence, paragraph 1.22)

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?

| |
|---|
| We do not feel we can usefully respond to this question in depth as we do not have extensive experience of working with financial advisers.<br><br>We are aware, anecdotally, that many financial advisers fail to explore clients' social motivations and lack skills in presenting social investment options, if they do so at all, in a way that is clear, fair and not misleading. |

**QUESTION 8: LABELLING SOCIAL INVESTMENT OPTIONS**

(Call for evidence, paragraph 1.23)

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?

| Yes: | No: | Other: |
| --- | --- | --- |
| | | |

## QUESTION 10: LAW OF SOCIAL ENTERPRISES

(Call for evidence, paragraph 1.25)

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?

| Yes: | No: | Other: |
| --- | --- | --- |
| | | |

## FURTHER COMMENTS:

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.

| Below we set out our thoughts first on general legal principles, followed by our thoughts on "options for reform" in respect of the Guidance for Trustees that the Law Commission issued in 2014. Finally, we attach a draft *Responsible Investment Bill* which we published in 2014 by way of offering an indicative working document to promote discussion on the need for primary legislation to promote long-term responsible investment. The draft was worded with that purpose in mind, rather than as an attempt at detailed parliamentary drafting. Although not explicitly focused on social investment, we hope it may be of interest to the Law Commission in undertaking its work on social investment and pension funds.<br><br>In respect of general legal principles (as distinct from the various issues raised re industry practice, scheme size, etc), the questions being asked in this consultation would appear, in large part, to have been answered the Law Commission's 2014 Report on Fiduciary |
| --- |

Duties of Investment Intermediaries.

So far as trust-based schemes are concerned, the question re social impact investing in the second sentence of paragraph 1.3 of the Call for Evidence and the more detailed question on the same subject in paragraph 1.2 of the Background Material are, in all essentials, answered by the summary of the Law Commission's view of the relevant law contained in paragraph 1.5 of the Call for Evidence. Further, these questions are effectively covered in the Law Commission Guidance of July 2014, which is annexed to the Background Material (and which ShareAction has generally found to be useful over the last two years although we make some suggestions below as to how it could be made yet more helpful).

Paragraph 1.7 of the Call for Evidence states that the Law Commission’s 2014 Report concentrated on (i) DB schemes and (ii) negative screening, whereas the present project is focussed on (i) DC schemes and (ii) positive investing for social good. We do not think these shifts of emphasis materially alter the legal considerations, for two reasons.

Firstly, rather than the differences between DB and DC schemes, we think that the key distinction in the present context is between, on the one hand, DB scheme investments and DC scheme investments that are not held in a fund that a member has actively chosen (i.e. where the DC scheme has only one common fund or where there are fund options but the investments in question are held in a default fund) and, on the other hand, DC scheme investments that are held in an actively chosen fund (e.g. an ethical, green or other socially oriented fund).The Law Commission’s “significant financial detriment” test applies similarly to both DB schemes and common fund / default fund DC schemes, whereas in relation to actively chosen funds it does not apply. This is stated in paragraph 6.36 of Chapter 6 of the Law Commission’s 2014 Report, which also contains a more detailed exposition of this point in paragraphs 6.88 to 6.90.

Secondly, the discussion of “non-financial factors” in Chapter 6 of the 2014 Report gave three examples of non-financial concerns, all of which, in our view, are relevant to the legal questions canvassed in this Call for Evidence.

The first example was “decisions aimed at improving beneficiaries’ “quality of life”” (paragraphs 6.40 to 6.46). The 2014 Report concluded that these may be “a factor in deciding whether to invest in local infrastructure or social projects”, as in the case of the Strathclyde Pension Fund’s New Opportunities Fund (paragraph 6.42). This is clearly relevant to the present consultation.

The second example was “decisions aimed at showing disapproval of unethical conduct” (paragraphs 6.47 to 6.49). This was focussed on negative screening (apart from the quotation from Lord Nicholls in paragraph 6.68 referring to “the *inclusion* or exclusion of particular investments” (our emphasis)). None the less, we think that it is clear that the

same rationale for taking into account members' ethical concerns applies equally to "positive screening". This example is therefore also germane to social investing.

The third example was "decisions aimed at improving the UK economy". The discussion on this category concluded that such a decision " is more likely to be a non-financial one than a financial one" and would be "subject to the same tests" as apply to the two previous examples i.e. the two-part test relating to members' concerns and to there being no risk of significant financial detriment to the scheme (paragraph 6.58). We think that this example would cover, for instance, infrastructure projects or social investments whose financial benefits (if any) to the portfolio were "too remote and insubstantial" to be considered as financial factors (paragraph 6.53).

In summary, therefore, the Law Commission has, in our view, already set out, in effect, its views on the legal scope for social investment by trust-based schemes. The key questions, therefore, seem to be whether these views contain "legal barriers" to social investment by pension funds (Background Material, paragraph 1.4 and Call for Evidence, Question 2) and what we see as the "options for reform" (Background Material, paragraph 1.5).

ShareAction is supportive of the Law Commission's two-part test in relation to non-financial factors but we do think there are several respects in which the Law Commission's current statement of the law in this area could be clarified in order to make it more favourable to social investing (and, indeed, to the consideration of non-financial factors generally). We would like to propose in the context of this 2016 consultation that such changes be reflected in revisions to the Law Commission's Guidance for trustees.

The potential "options for reform" might include the following:

Firstly, the current Law Commission view is that scheme trustees *may* consider non-financial factors (subject to the two-part test) but that they are not obliged to do so. (See, for example, the contrast in the Law Commission Guidance between the statement that trustees *should* take financially material factors (including financially material ESG factors) into account (paragraphs 1.20 to 1.22) and the *"may"* wording in relation to non-financial factors (paragraph 1.25.). We suggest that the Law Commission might confirm in its Guidance to Trustees that it regards the trustees' power to take non-financial factors into account as a *fiduciary* power. If this were the case, trustees would be under a legal obligation to consider periodically whether to exercise the power. That would chime with the obligatory triennial reviews of their SIP, which would have to reflect their policy on this issue.

In our view, such a confirmation need not be regarded as a shift in the Law Commission's position: it would merely make explicit in its Guidance what is already implicit.

Secondly, we propose that the Law Commission confirm that if scheme trustees decide not to exercise their power to take non-financial considerations into account, they should disclose their reasons for the decision to their beneficiaries, either on their own initiative or upon request. This would be in accordance with the principle that rights under private trust law for trustees to withhold their reasons for the exercise or non-exercise of their discretions should generally not apply to pension schemes (see further below).

Thirdly, there is the question of what would constitute a good reason for trustees to decide not to exercise their power to consider non-financial factors (other than the failure of a specific potential social investment to pass the two-part test). Arguably, that question highlights a problem with the Law Commission not saying outright that scheme trustees *should* exercise this power unless they consider that there is good reason not to do so. The current stance seems to conflict with the Law Commission's acceptance that, in relation to the beneficiaries of a pension scheme, "best interests" and "benefit" are not purely financial concepts. (See, for example, the discussion in paragraphs 4.33 to 4,57 of the 2014 Report, which are reproduced on pages 29 to 35 of the Call for Evidence.)

For instance, paragraph 1.26 of the Law Commission's Guidance for trustees states "if trustees wish to consider non-financial factors, they should ask two questions " (i.e. the two-part test). It is, however, hard to see what legal basis the trustees could have to "wish" to do this other than to promote the "best interests" of their beneficiaries. This is especially so since the Guidance makes it clear that the trustees must not seek to impose their personal views on non-financial concerns (paragraphs 1.27,1.28 and 1.32). Furthermore, if "best interests" (and "benefit") include a non-financial component, does it not follow that trustees *should* at least consider how they might promote their beneficiaries' non-financial best interests in ways which are consistent with their overall best interests?

Fourthly, there is the related question of "Do trustees have to consider members' views?", which is the heading to paragraph 1.32 of the Guidance. This paragraph states that trustees *may* do so but that there is no legal requirement. If, however, the Law Commission took the view that, as argued above, trustees *should* try to promote their beneficiaries' non-financial best interests, it would seem to follow that they *should* also consider members' views as a part of that process (i.e. in order to apply the two-part test).

There is also a wider dimension to this question. Although in both the Guidance and the 2014 Report this issue of considering members' views is primarily addressed in the context of non-financial considerations, it seems clear from the 2014 Report, in particular, that, in the Law Commission's opinion, trustees do not have to consider members' views when making investment decisions of any kind i.e. in relation to financial as well as non-financial factors (see paragraphs 6.79 to 6.83 and the cases there cited).

It seems strongly arguable, however, that the Law Commission's stance in this regard is a example of the importation into pension scheme trusts of the paternalistic principles

evolved in the context of private family trusts. This is an approach which the 2014 Report elsewhere recognises to be the mistaken: see paragraphs 4.30 to 4.32, reproduced on page 28 of the Background Material. As those paragraphs explain, the key point here is that pension scheme members are not "volunteers" or the recipients of a settlor's "bounty" but have paid for their benefits. In private trust terms, they are settlors as well as beneficiaries and their views deserve a degree of respect that reflects this dual status.

On that reasoning, it would be illogical to argue that any encouragement or requirement for trustees to take account of their beneficiaries' views should be limited to non-financial matters only, especially when it is agreed on all sides that it is the financial considerations that are of primary importance. Moreover, many issues that trustees may need to consider in their investment or stewardship policies have both financial and non-financial aspects. Climate change and executive pay are just two, very different, examples. It would be strange if the law required trustees to consider members' views on only certain aspects of the same policy. In the case of social investment, which *by definition* has both financial and non-financial objectives, this distinction appears especially untenable.

Fifthly, we would like to propose that the Law Commission reword the first part of its two-part test in relation to trustees taking account of non-financial concerns. The current wording requires trustees to have good reason to think that "scheme members would share the concern" (e.g. in paragraph 1.25 (1) of the LC Guidance). This could be read as implying that the trustees must personally "share" the concern in question before they can take it into account.

Such an interpretation would be contrary to paragraphs 1.27, 1.28 and 1.32 of the LC Guidance, as mentioned above. None the less, ShareAction has had recent first-hand experience of this argument being advanced by a leading firm of solicitors in relation to a very large pension scheme. This is therefore not a theoretical point.

The revised wording could be on the lines of: "trustees should have good reason to think that the factor in question would be of concern to scheme members".

In our view the various clarifications/ changes proposed above to the Law Commission's Guidance would encourage trustees to approach social investing with a more positive attitude. They would have more reassurance that they were acting correctly in factoring in non-financial concerns.

At the same time, none of these changes would restrict trustees' discretion in any way. This is an important point, given the potential for conflating, on the one hand, consulting beneficiaries and having regard to their views and, on the other hand, giving beneficiaries the power to direct trustees in their investment decisions. This distinction should be clear and would be helpful if emphasised.

The above proposals apply only to trust-based schemes (which for these purposes should be regarded as including the LGPS). As to contract-based schemes, in our view the contract-based model is inherently inferior in respect of protecting and promoting the interests of beneficiaries. Whilst various reforms may narrow the gap, the only fully satisfactory solution would be to revert to an entirely trust-based system, which would include the introduction of fiduciary oversight for existing contract-based arrangements. We appreciate that this point goes beyond the scope of the current consultation.

**Be it enacted [etc] as follows –**

**1. Long-term investor: definition**

| | |
|---|---|
| (1) In this Act ***"long-term investor"*** means any of the following persons or institutions -<br>(a) the trustees of a trust scheme as defined in section 124(1) of the Pensions Act 1995;<br>(b) any person or institution to whom the trustees of a trust scheme have delegated any of their *investment functions* and any sub-delegates, in relation to the performance of such functions only;<br>(c) any person or institution whom the trustees of any trust scheme have appointed to advise or assist them in the performance of their *investment functions*, in relation to the giving of such advice or assistance only;<br>(d) undertakings authorised under the Financial Services and Markets Act 2000 to carry on long-term insurance business, that is, the activity of effecting or carrying out contracts of long-term insurance within the meaning of the Financial Services and Markets (Regulated Activities) Order 2001 (S.I. 2001/544), in relation only to the effecting or carrying out of any contract falling within paragraph VII (Pension fund management) of Part II of Schedule 1 to that order, any external managers of *investments* held in relation to any such contract and any sub-delegates of such managers, in relation to such management only;<br>(e) any provider of a personal pension scheme as defined in section 1(1) of the Pension Schemes Act 1993 and any person or institution managing the *investments* of such a scheme and any sub-delegates of such managers, in relation to such management only; and<br>(f) any person or institution designated in regulations under subsection (2) as a *long-term investor*, either generally or in relation to prescribed *investment functions* only.<br>(2) The Secretary of State may by regulation<br>(a) designate further categories of persons or institutions as *long-term investors* either generally or in relation to prescribed *investment functions* only;<br>(b) provide that where, by virtue of subsection (1), a person or institution is a *long-term investor* in relation to prescribed *investment functions* only, that person or institution shall be designated as a *long-term investor* in relation to further | *(Clause 1(1) defines "long-term investors", the market participants to which the Act is to apply. (For a brief summary description of each category in paragraphs (a) to (f) of sub-clause (1), see clause 3 below.)*<br><br>*Clause 1(2) provides for regulations to add new categories of long-term investors (whether wholly new entities or existing long-term investors in respect of additional roles) and for these categories to be changed from time to time (but not so as to narrow the original definition in the Act).*<br><br>*There are perhaps two points in particular which should be highlighted here for discussion:*<br><br>*First, the initial list of long-term investors does not extend beyond pension savings. It can be argued that pensions are a special case, especially with the advent of auto-enrolment. There is, though, also an argument for extending the scope of the Act to other forms of long-term savings (for example, ISAs). That could be achieved from the outset by additions to the list in sub-clause (1) or subsequently by regulations under sub-clause (2)*<br><br>*Second, the list of long-term investors includes insurance companies. This does, however, raise the vexed issue of the governance of contract-based schemes and, in particular, the question of whether it is realistic to try to devise structures that will give beneficiaries a level of protection that is comparable to fiduciary standards, given the conflict of interests between shareholders and policyholders. That in turn leads to the question of whether there should be a move to a wholly trust-based UK pensions system, coupled perhaps with a policy of scheme consolidation, on the lines of the Australian model detailed in the Law Commission's Consultation Paper. There is also a related "legacy" issue of existing contract-based arrangements and whether it would be possible to add any kind of fiduciary overview to these (which would itself likely require primary legislation) . These problems may need to be resolved in tandem with the development of the bill.*<br><br>*Clause 1(3) is explained under clause 3, to which it relates.)* |

# Responsible Investment Bill

ShareAction
the movement for Responsible Investment

*(This draft bill is intended to serve as an indicative working document to promote discussion on the issues which arise from it, with a view to arriving at a consensus among stakeholders as to the need for primary legislation to promote responsible long-term investment and as to the precise scope of any such legislation. The draft has been worded with that purpose in mind, rather than as an attempt at detailed parliamentary drafting.)*
*(N.B. As an aid to easier reading, all defined terms in the draft are shown in italics, with the related definitions being found in clause 13 (with the exceptions of "long-term investor" and "investor", which are defined in Clauses 1(1) and 1(4) respectively).)*

**A BILL TO make provision for responsible and accountable long-term investment by institutional investors; and for connected purposes.**

*(In relation to the above short title, it may be helpful to outline here the main themes of the draft bill:*
*First, the bill envisions a fairly "high level" Responsible Investment Act that would clear away any obstacles (real or perceived) under existing common law and that would provide a framework for more detailed changes, which would be made either by statutory instrument or through changes to the FCA Rulebook. It is envisaged that the whole package of primary and secondary legislation would come into force on the same date: a "Responsible Investment Day". (It is likely that most of the regulations would be made under already existing primary legislation, including the Pensions Acts and the Companies Act , rather than under the new Act.)*
*Second, the bill follows the general approach adopted in previous ShareAction (formerly FairPensions) publications, including "Protecting Our Best Interests: Rediscovering Fiduciary Obligation (2011), "The Enlightened Shareholder: Clarifying investors' fiduciary duties" (2012) (which contained specimen draft legislation for a fiduciary investor equivalent of section 172 of the Companies Act 2006) and "Our Money, Our Business: building a more accountable investment system" (September 2013).*
*In essence, this approach retains the core fiduciary principle of undivided loyalty to the beneficiaries but calls for a broader interpretation of beneficiaries' "best interests" and for more accountability to, and participation by, beneficiaries. Further, whilst high standards are demanded of fiduciary investors, the aim is also to repose trust in them in relation to the exercise of their discretions: the emphasis is on empowering fiduciaries to act in the enlightened interests of their beneficiaries rather than imposing restrictive burdens. The corollary is that, for this approach to work, fiduciaries need to have the requisite expertise and resources and to be free from inherent conflicts of interest.*
*In drafting the bill we have taken into account (among other sources) relevant recommendations in the "Kay Review of UK Equity Markets and Long-term Decision Making: Final Report "(July 2012) and the Government's Response "Ensuring Equity Markets Support Long-term Growth" (November 2012).*
*We have also had regard to relevant aspects of the Law Commission's Consultation Paper "Fiduciary Duties of Investment Intermediaries" (October 2013). However, when the Commission's final report is published, its implications for the current project will have to be evaluated.)*

THE SOCIETY OF PENSION PROFESSIONALS
leading pension thinking

Email: commercialandcommon@lawcommission.gsi.gov.uk.

December 15th 2016

Dear Sir or Madam,

**PENSION FUNDS AND SOCIAL INVESTMENT: CALL FOR EVIDENCE**

We welcome the opportunity to contribute to the above call for evidence.

**INTRODUCTION TO THE SOCIETY OF PENSION PROFESSIONALS**

SPP is the representative body for a wide range of providers of advice and services to work-based pension schemes and to their sponsors. SPP's Members' profile is a key strength and includes accounting firms, solicitors, insurance companies, investment houses, investment performance measurers, consultants and actuaries, independent trustees and external pension administrators. SPP is the only body to focus on the whole range of pension related services across the private pensions sector, and through such a wide spread of providers of advice and services. We do not represent any particular type of provision or any one interest - body or group.

Many thousands of individuals and pension funds use the services of one or more of SPP's Members, including the overwhelming majority of the 500 largest UK pension funds. SPP's growing membership collectively employs some 15,000 people providing pension-related advice and services.

This call for evidence has been considered by SPP's Defined Contribution and Investment Committees, which comprise representatives of actuaries and consultants, investment houses, pension lawyers and product providers.

**RESPONSES TO THE CONSULTATION QUESTIONS**

**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?**

Paragraph 1.14 of the call for evidence identifies three factors, which can be barriers to infrastructure investment, i.e. a lack of scale, the need for liquidity and the demands of regular mark to market valuations.

Another significant factor is that funds will often be reluctant to take on risk at the construction stage of an infrastructure project, even though it is then that the prospective returns are likely to be highest.

**Question 2: Do any of those barriers relate to issues of law and regulation?**

Provided that trustees and providers are satisfied that a social investment is in the best financial interests of the members, we are not aware of barriers presented by issues of law and regulation.

However, the position could be complicated if the result of a current Financial Conduct Authority (FCA) consultation, on whether to make a market investigation reference to the Competition and Markets Authority on the investment consultancy market, results in the provision of institutional investment advice sitting within the FCA's remit. This is in the light of the FCA's rules requiring financial advisers to perform a "suitability test" before recommending an investment to clients and its previous comments (already noted in your consultation at paragraphs 1.19 to 1.21) about social impact investing being risky, "*a form of venture capital, in that investments are made in often small, unlisted companies which can*

*have a high failure rate*", and "*the expected social impact may not be achieved and there may be no financial return either*".

The risk would be that the investment consultancy sector could be inhibited in advising clients on measures to progress social investment by the suitability issue (given the FCA's expressed views) in an environment of regulatory change. The view could be that it was a 'regulatory minefield'.

It would be desirable for the Law Commission's conclusions and recommendations to be consistent with any changes in the regulatory landscape arising from FCA's current consultation.

**Question 3: Is the size of funds a major issue? If so, are there legal obstacles to scheme mergers?**

Only the largest funds are likely to be in a position to consider infrastructure investment.

If schemes considered it appropriate to merge specifically to facilitate socially significant infrastructure investment, there would be no fundamental legal obstacles. One difficulty, which can impede so called bulk transfers of members from one defined contribution scheme to another, which could be part of a scheme merger, is the provision of an actuarial certificate as a condition of such a transfer. There can be practical difficulties in providing the certificate, since the terminology associated with it is based on the situation of defined benefit, rather than defined contribution schemes.

**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?**

This question will most appropriately be answered by individual employers and pension providers, but in the experience of our commentators, most providers will offer perhaps one or two ethical funds, for which the take up is low, because, as the call for evidence recognises, most members are placed in a default fund and do not then choose to switch.

We have no data on returns, but it also needs to be taken into account that ethical options will incur higher annual management charges – perhaps 1.5% compared to the 0.75% charge cap for default funds. Active member choice would therefore be essential and our commentators' experience is that the proportion of those choosing is in the low percentiles.

**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?**

The question of scale is an important one. Investment opportunities within defined contribution schemes need to be investible by schemes with many, perhaps hundreds of millions of pounds. Although one may envisage any individual social investment as not being a large allocation of any fund, the size of the investment opportunity may well still be an issue. This is all the more relevant when the need for liquidity in an investment is considered, with ready prices available at which trades can take place frequently, even daily. Any pooling of opportunities into a fund will still have to take account of underlying investment liquidity.

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

We are not sure that more options would encourage greater engagement. Greater choice could make decision making more difficult and reinforce the existing strong tendency to make no choice and to be placed in a default fund.

**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?**

A critical issue is that balancing return and social outcomes is not straightforward, as the need is to put a price/value on an outcome, such as a rehabilitated offender.  Because the sector seems to be in its infancy and somewhat untested, 'suitability', as noted above, might prove a challenging hurdle, particularly if investment consultancy comes under the FCA's regulation.

In relation to question 6(b), this might not be a realistic trade-off for a pension fund aiming to provide a good financial outcome for members at retirement.

**Question 7: In practical terms, how can financial advisers:**

**(a) Best explore their clients' social motivations?**

**(b) Present social investment options in a way, which is clear, fair and not misleading?**

We suggest that any social motivations can be addressed through the Fact Find, which forms part of the investment advice process.

We note that there is no question 8.

**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?**

In our view, the product details for specific investments typically give a clear description of the investment option in question.

As the question recognises, standardisation of labelling or description might not be straightforward and would need to be kept under review, but might be helpful where it was possible.

**Question 10: Is there a need to review the legal framework around social enterprise, to make it easier for such enterprises to borrow money and receive investment?**

On the face of it the structure described in paragraph 1.24, which operates in France, could be attractive. There might also be useful parallels in the mixed motive investment provisions of the Charities (Protection and Social Investment) Act 2016.

Yours sincerely

Lucinda Cunningham,
Commercial and Common Law Team,
Law Commission, 1st Floor Tower
Post Point 1.53,
52 Queen Anne's Gate, London
SW1H 9AG

15th December 2016

Dear Law Commission,

**Re: Pension funds call for evidence**

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?

Pension funds are exceptionally risk averse – not simply in the obvious sense that they care deeply about preserving capital, but more in the reputational sense that they wish to be seen to be making cautious investments. This can be counterproductive, as it leads to an excess of investment in markets that are past their peak and about to decline – for example, coal – and too little investment in organisations with a largely risk-free business model (eg a subsidised solar farm) but no track record or prestigious London offices.

Question 2

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

With the barriers being more those of culture and convention than law, the main issues for law and regulation are those that enable ease of access to new entrants in the pension marketplace. The main opportunity for social investment in pensions will not come from established funds, who are unlikely to change their culture whatever the incentives, but from new entrants that initially serve a niche market and gradually establish themselves as a mainstream alternative.

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?

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(c) What sort of returns do they provide?

We have been in touch with a number of social enterprises seeking suitable pension schemes for their employees, and the options available are disappointing to say the least. Ethical screening is partial and almost always succeeds only in a few very restricted areas (eg tobacco and gambling) while continuing to support a huge range of unsustainable and / or social divisive business models. Positive investment in social enterprises is almost unheard of.

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?

We believe that this is definitely the case. Not only is a particular market segment not being served at present, almost all savers have a deep level of mistrust of, and disengagement from, their pension funds. The absence of mutuality – eg saver representation on pension boards – coupled with the distinct absence of any mission, purpose or character to the portfolio of investments, makes the entire pension industry unappealing and exclusive.

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 average rate of return on pensions has hovered around the 3% mark for many years, and this compares very poorly to the returns that can be achieved in the social enteprise sector. Community energy commonly offers 4-6% returns, social housing projects 3-5%, and sustainable transport initiatives 5-7%. Mutual and community providers of telecoms offer 3-5%, agriculture 3-4% and ethical retail 2-4%. These represent an array of businesses both large and small, all offering equity shares (or bonds in a few cases), and presently ignored by all pension funds.

Lower returns than these could only be justified where there is exceptionally low risk, or the expectation of asset appreciation over the long term. It would be unwise to confuse investment and philanthropy – the two need to be pursued independently and funds specifically allocated to each. A pension fund that does not reliably grow its capital, and choose its investments with this in mind, cannot reasonably be described as such. There is also the danger that social enterprise that builds productive capacity and creates wealth in a manner serving the whole community will 'fall between two stools' if social investment is held to be a fraction of the overall fund that is effectively written off; the remainder of the fund is them likely to be invested according to criteria of extreme conservatism in an attempt to compensate for losses in the philanthropic fraction.

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?

This is beyond our remit, other than to say that a healthy IFA sector in which advisors are seen to be independent of their commission-based income is important to maintain trust.

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?

This is hazardous, as it risks eradicating the very diversity that is presently missing. We would rather see funds have the opportunity (indeed, the obligation) to state their individual ethical position.

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?

We would advise caution here. The mutual social enterprises are already able to employ equity investment vehicles, and by and large choose to use withdrawable par value shares in place of transferable share capital for reasons of financial prudence and ethics. The issue is more about creating an investment marketplace that can work with these 'common wealth' models of investment than encouraging social enterprises to ape the very businesses they are seeking to differentiate themselves from.

In particular, and social enterprise called upon to distribute profits to investors is immediately faced with a severe conflict of interest. This is why CICs limited by share have proved much less popular than mutual societies. Mutuals do not pay dividend on shares, but instead pay interest – a business expense – set at a level sufficient to attract and retain investment. This delivers highly respectable returns (and cruically, stable and predictable returns) but does not place investors in an antagonistic relationship with social objectives.

For this reason, we do not support reforms to allow a greater distribution of profits, but instead would support the shift already underway to interest-bearing share capital with no access to profits.

Yours sincerely,

Somerset Co-operative Services CIC

To: commercialandcommon@lawcommission.gsi.gov.uk

Below is my response to the questions posed in your call for evidenced for '**DC pension funds and social investment'** - dated November 2016 – the following document:
http://www.lawcom.gov.uk/wp-content/uploads/2016/11/pension_funds_call_for_evidence_Nov2016.pdf

**Introduction**

I have specialised in retail 'sustainable, responsible and ethical investment' (SRI) for over 20 years. This has included previously being responsible for the £4bn Friends Provident 'ethical/SRI' proposition (SRI Marketing Manager) as well as being the (not for profit) UKSIF director responsible for developing their retail proposition (retail sub committee chair).

My work now involves a range of specialist consultancy and the provision of services that are helping to raise awareness of (and improving understanding of) retail SRI options in the life, pension and investment markets.

The online services I run are unique, free to use and directly address a number of the issues raised in your questions.

These include:

- **Fact finding.** The SRI 'StyleFinder' fact finding tool is designed to help users work out the 'types' of ethical/SRI options that best suit their (or their clients) personal opinions http://stylefinder.fundecomarket.co.uk/
- **Identifying and understanding ethically appropriate fund options**. Fund EcoMarket is a 'whole of ethical/SRI market' fund information hub and search tool that segments different SRI/ethical options into 'styles' in order to make their core ethical/SRI strategies clearer. It offers filters, text and links to most of the major funds in this area in order to facilitate further research and help match an individual's needs to fund options. (Detailed fund information sits within the OEIC entries, but relates also to linked pension (sub) funds) http://www.fundecomarket.co.uk/
- **Generic market information**. sriServices.co.uk is a free to use generic (not fund specific) adviser information and support site that sets out the different SRI & ethical investment issues, approaches and strategies. The site also explains why diversity is essential in this market - and has links to literature and other related websites. http://www.sriservices.co.uk/

These are based on experience working 'on the inside' of the UK retail market's first and largest ethical fund range for 12 years (Friends Provident – then owner of F&C and the Stewardship brand. These funds are now split between different fund managers) and working alongside other fund managers, advisers and the media in a range of 'specialist' capacities. The aim of this work is to make it easier for users to bring SRI and ethical options into their strategies by explaining the workings of this diverse, dynamic and increasingly important area. Many of the questions asked in this consultation are directly relevant to the reasons I run these web sites – to try to demystify investments of this kind. As far as I am aware there are no comparable resources or tools available.

I would be happy to help further as I believe this area has much to offer both pension members and wider society.

Please contact Julia@sriServices.co.uk if you would like further 'independent' dialogue.

With kind regards,

Julia Dreblow
Founding Director – sriServices and www.FundEcoMarket.co.uk

**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?

**Given the wording of the later questions I interpret 'social investment'** as 'any investment that considers ethical, social or environmental issues to a significant extent' – which I refer to as 'SRI'.

This area includes DC pension fund options that are normally labelled as 'sustainable, responsible or ethical investments'. These typically have 'screened or themed' investment strategies – or both. Such funds typically hold equities and or fixed interest investments.

My view is that direct investment into infrastructure and social impact investments is problematic for DC schemes – for risk management and other reasons.

The response below therefore focuses on how to increase 'positive' investments via collective fund structures.

This is in part as this is not my area of expertise but also because DC scheme members are generally better advised to gain exposure to such investments through collective funds where risk and price can be properly managed.

In general, if such investments are sufficiently financially attractive they will be picked up by pension fund (and other investment) managers.

However, investments of this kind are more likely to initially be attractive to funds that are designed to bring 'ethical, social and environmental' issues and/or longer term, ESG (environmental, social and governance) factors into their investment strategies.

There is wide a spectrum of consideration (and integration) of such issues into fund policies.

Funds that are set up to focus on such issues alongside financial factors are often (but not always) labelled 'Ethical screened' or 'SRI themed'. Other funds that may look for opportunities of this kind are those offered by companies where a corporate level decision has been made to bring such matters into the regular research or investment processes. This includes 'ESG integration' and 'Responsible Ownership' type strategies – although such strategies are rarely communicated to individual investors. (See Fund EcoMarket 'SRI Style' classifications.)

The relatively low take-up of funds with clear and explicit 'ethical, social and environmental' remits is a key barrier to greater investment in organisations that can deliver stronger social and environmental outcomes.

A major challenge therefore is **how to grow investment funds where there such issues form a core part of the investment strategy (both in terms of the number of funds available and in scheme member take up).**

A major barrier to greater DC pension fund investment of this kind is the limited attention (priority) given to funds that can help deliver more positive, longer term outcomes – often over time scales which align with those of pension investors.

**Related barriers include the following:**

- **Myths and misperceptions**. Dated views persist around the subject of performance, pricing and strategies of ethical/SRI options. This area offers a wide a choice of ethical/themed strategies to cater for different individual opinions. Many of these are competitively priced with sound performance. As with any other sector, there is variation – however fund managers who are active and successful in the SRI/ethical pensions market demonstrate its potential. Examples of success include Standard Life, Aviva/ Alliance Trust, Kames/Aegon , BMO GAM (F&C), Friends Provident (now part of Aviva). See the attached list of all existing SRI pension fund options (source: Fund EcoMarket).

- **Complexity / lack of understanding**. Diverse strategies and terminology have evolved over the last 30 + years to meet client's different aims, opinions and financial objectives. The diversity of social, ethical and environmental strategies (ie how issues and approaches are combined) can make the area difficult to understand. This leads some people to comment that some 'ethical' options are inconsistent or misleading – whereas in most cases they are simply designed to be different. Some recent development in 'rating' such funds risk exacerbating this problem and misleading clients, as this area is more subjective and nuanced than many acknowledge.

- **Low expertise.** There is a (somewhat understandable) reluctance to offer or promote products where clients may know more about some aspects of the strategy than investment professionals (eg advisers) might. Offering funds where there is a risk of having to discuss issues as diverse as animal testing, climate change, and human rights is not always welcome. Also, this area has not been historically well supported (either in terms of quantity or quality) by training bodies so this is not likely to change in the short term. (This is the reason I set up free support tools www.FundEcoMarket.co.uk for fund selection support and www.sriServices.co.uk for generic 'understanding this market' adviser support.)

- **Lack of awareness**. Given that this area is relatively low profile scheme members and trustees can not be expected to request or support options they are not aware of or do not understand.

- **Poor marketing/terminology and support information.** In most cases those who write information explaining fund options for scheme members (and trustees) work from templates that focus on conventional financial metrics only. Values, opinions and the integration of megatrends and associated risks do not form part of their methods. The information presented to trustees and members is therefore often very limited and potentially misleading. Where an 'ethical' option exists this label is generally insufficient to explain what the fund actually does - and can be unhelpful as the term 'ethical' is disliked by some.

**Question 2**
**Do any of those barriers relate to issues of law and regulation?**

Yes.
A failure to raise the profile of core ESG issues as part of scheme design is a failure.
The fact it is not always easy for individuals to access funds that suit their personal needs is a further failure.

> **Note - Recent Law Commission/Pension Regulator** trustee governance guidance for DC schemes is welcome, however this should be widened to apply to all pension schemes - and strengthened in terms of its profile and reach.
> For DC schemes a greater emphasis should also be put on member choice and clearer explanation of strategies and options.

I would be happy to discuss possible solutions.

**Question 3**
Is the size of funds a major issue? If so, are there legal obstacles to scheme mergers?
N/A

**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?

My previous role was at Friends Provident – a pension provider with a market leading reputation in the provision of 'ethical' pension options. I now operate independently in order to help raise the profile of this area.

The whole of market Fund EcoMarket database shows there are currently 137 DC pension fund options available.

- Go to www.FundEcoMarket.co.uk .
- In the 'Product' filter field select 'Pension' – and use the blue button to 'search' options.

This figure (137) includes subfunds (ie duplicate/mirror options offered by different distributers) but not individual dated entries for Lifestyle options. For example - the 'Aegon Ethical Lifestyle Pn ARC' range offers numerous end dates to help manage risk but is listed as a single option.

- From my previous role I know that SRI/ethical funds (notably Stewardship, which totalled over £4bn at the time - 2008) are (or were) regularly used as default funds providing price, performance etc was appropriate. This included Stakeholder schemes.
- Take up of ethical options was also high at that time. (Total FP Stewardship Pension assets at that time exceeded £1bn and appear to have remained static (via their core pension and NGP ranges. See https://www.friendslife.co.uk/funds/stewardship/funds-and-performance.jsp).
- Friends Provident is now part of Aviva. These funds are now managed by a third party.

The success of the Friends Provident ethical pension activity shows that where sales and marketing effort supports well managed funds of this kind take up is strong.

**(a) What proportion of people take them up?**

- Take up varies but *can* be very strong. See above.
- To get clear figures on this it may be useful to talk with the companies. Please note - relatively few people know how to unpick fund and subfund statistics in order to avoid double counting.
- Also see NEST.org – where takeup appears low (which may be linked to the 'barriers' listed above as expertise and support may be limited).

**(b) What sort of returns do they provide?**

There is much freely available information online showing performance and charges (Apologies I do not have time to work through these in detail for you).

Three examples are shown below (to mid December 2016).

- **The Aviva Alliance Trust Sustainable Futures Managed Pension Fund** shows the following performance - Trustnet show annual charges ranging from .40 and .60bps as at 16/12/2016

**Cumulative Performance**

| | YTD | 3m | 6m | 1y | 3y | 5y |
|---|---|---|---|---|---|---|
| Fund | 10.84 | 1.97 | 11.21 | 14.13 | 30.92 | 82.48 |
| Sector | 12.55 | 2.57 | 11.66 | 15.39 | 24.19 | 53.99 |

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- **The Kames Ethical Equity Pension** fund (also marketed by Aviva) is available at 0.75 bps - according to Trustnet. Trustnet shows the following cumulative performance (as at 16/12/16):

**Cumulative Performance**

| | YTD | 3m | 6m | 1y | 3y | 5y |
|---|---|---|---|---|---|---|
| Fund | -1.08 | -0.71 | 8.33 | 2.01 | 20.36 | - |
| Sector | 8.60 | 3.35 | 14.48 | 12.56 | 18.65 | 67.55 |

**Trustnet** indicates that this Kames subfund has not existed for 5 years, however searching the primary fund shows that 5 year Kames Ethical Equity (OEIC) performance is +88.5% which compares favourably with the UK All Companies index which has achieved +68.0% over five years (to 14/12/2016).

These figures are not directly comparable – but are indicative of an ability to outperform a commonly used benchmark.

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- **Standard Life Ethical UK Pn** S2 shows the following performance on Trustnet - with annual charges showing from 0-0.4 bps. (to 15/12/2016)

**Cumulative Performance**

| | YTD | 3m | 6m | 1y | 3y | 5y |
|---|---|---|---|---|---|---|
| Fund | -0.10 | 2.91 | 9.76 | 2.75 | 19.09 | 95.57 |
| Sector | 8.60 | 3.35 | 14.48 | 12.56 | 18.65 | 67.55 |

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The performance of the NEST 'ethical' options (F&C / BMO GAM) is also strong.

These figures are indicative examples – from simple online searches. Please use these with caution as pricing may not be reflected in these figures. The shorter term performance is also indicative of the reality of excluding some sectors (eg oil and gas).

Many other options are available in various combinations from a range of fund managers, product providers and platforms. These include well known companies such as Standard Life, Kames, Aviva (Alliance Trust), Friends Life (now part of Aviva), OWM and Zurich. Please note ethical, financial and other contract details vary significantly across these options.

Please note I do not normally research performance or price and have not worked through the above details in depth. Please let me know if you would like me to do so.

**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?

To answer this question it is useful to know what exists at present.
Across the retail UK listed fund market there are 137 options according to www.FundEcoMarket.co.uk

This number is greatly reduced if duplicate funds are excluded - however this illustrates the number of access points into ethical/sustainable pension fund options.

These break down as follows:

**SRI Style Classification – all (UK regulated) retail pension funds**
**source: Fund EcoMarket**

**23 - Sustainability Themed**
**38 - Ethically Balanced (ie combine positive and negative ethical screening criteria)**
**45 - Negative Ethical (ie focus on avoidance related ethical criteria)**
**17 - Environmental Themed**
**0 - Social Themed**
**2 - Faith Based**
**12 - Unclassified (ie not yet researched/insufficient information available)**

Fund EcoMarket does not list individual funds within the 'Responsible Ownership' and 'ESG integration' SRI Styles as the activity carried out within these 'corporate level' strategies often applies to all of a fund managers equity (and occasionally bond and property) funds and other assets. See www.FundEcoMarket.co.uk

If the DC pension market were to attract greater investment fund choice would undoubtedly expand – most probably initially with OEIC fund managers finding ways to offer pension units.

Experience tells me that when appropriate SRI/ethical fund options are offered to clients, properly explained and set within appropriate product structures they are successful. Conversely – when such options are simply labelled as 'ethical' and inadequately communicated they are liable to attract little investment.

The categorisations above illustrates why this does not work. The diversity of fund choice means that explanations beyond the label 'ethical' are essential if we are to avoid misleading scheme members.

Client engagement is therefore, in my view, a function of both communication and availability.

Experience also tells me that sustainable, responsible and ethical fund options benefits from far greater persistency - loyalty - than other investment types and that this is helpful to both scheme members and fund providers.

This is important because it indicates that such options offer a different 'investor experience' from conventional fund options that focus only on narrowly defined financial issues.

Ethical/SRI investors are more 'engaged' as they 'buy in to' more than simply performance. (As they are choosing options that mean something to them.)

I would be happy to discuss the implications of this for longer term savings products such as pensions if you wish.

About Fund EcoMarket:

www.FundEcoMarket.co.uk, which I run, lists all SRI/ethical pension fund options (and other retail products). It shows 'ethical / social / environmental information only.

As far as is possible all funds are segmented into 'SRI Styles' (segments) to make their core strategies easier for users to identify and understand.

Fund EcoMarket includes text, filters and links (supplied by fund managers). The site does not carry performance or charging information as this is available elsewhere (and expensive to purchase!).

On its most basic level it helps users to find ethical options. The 'SRI Styles' filter enables users to select the funds within the 'SRI Styles' that meet their core personal values or opinions (eg Sustainability Theme, Negative Ethical or Faith Based etc).

More specific filter options and text are shown within OEIC product options – but also relate to other products such as pensions. Policy and Features related filters allow users to filter by criteria such as 'Avoids coal, oil and gas majors' and 'Measures positive impacts' . Text and links to fund manager allow users to read more about ethical/SRI strategies. (This service is relatively new and still growing.)
The aim of this fund manager sponsored hub (launched in 2015) is to help explain the different SRI/ethical strategies and options so that advisers and others can make better informed decisions. This system is born of a long held desire to address the problems in this market.

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

Yes. See above.

People are ‘buying into’ more than simply performance (that they typically do not understand). If properly explained – ethical/SRI investors become far more engaged and more loyal than other investors (or scheme members) – all other factors are reasonably equal.

For further information on this I suggest you speak to experienced financial advisers – many of whom are members of the Ethical Investment Association (part of UKSIF).

**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?**

Yes (as listed above) there are at least 137 ways in which scheme members can potentially access this area.

These would almost certainly be more if demand were to increase.

With regard to delivering social impact via DC pension schemes my view is that it is important to focus on encouraging the uptake of funds that have a remit in line with improving social and environmental outcomes - rather than focusing on the attractiveness of individual projects.

Please see response to Q4 (d) for specific examples of funds that can help deliver positive benefits alongside competitive returns.

Also see response to Q1 on how attracting greater investment into screened and themed funds can help facilitate investment into projects which target specific social outcomes – providing their financial credentials are sound.

If support for this area were to be significantly strengthened new styles of fund would almost certainly emerge to reflect changing/ growing social, environmental and ethical concerns, risks and opportunities. (There are a number of screened OEIC funds that have interesting strategies in this area that are not currently available via Pensions). There are also fund managers with interesting corporate strategies that might also be attracted.

Such funds do not however normally claim to deliver specific social (or environmental) outcomes.

By avoiding (either implicitly or explicitly) companies with ‘unacceptable’ strategies (definitions vary) and looking for investments opportunities amongst more sustainably or more ethically managed companies (or other organisations) such funds gain greater exposure to more ‘positive’ companies.

Strategies vary significantly in this respect, but one notable recent development is ‘impact measurement’.

Impact measurement is in its relative infancy in the UK SRI/ethical fund market. The fund managers that responded to the 2015 Fund EcoMarket survey stating that they ‘Measured Positive Impacts’ included EdenTree, WHEB, Henderson, Impax, Jupiter, RLAM, Sarasin and Threadneedle. (See www.Fund EcoMarket.co.uk OEIC entries).

This is a growing trend that I expect to see more of in future.

Innovations such as this can bring diverse and often somewhat unexpected benefits if done well (well informed, transparent and subject to scrutiny). A growing emphasis on impact measurement could, for example, help drive down carbon emissions across all companies in a way that setting a required level of exposure to specific socially desirable holdings (such as in France) may not.

This is an example of why - in my view - retaining a UK Ethical / SRI fund market that is fluid, innovative and unconstrained in terms of precise definitions (and therefore able to come up with new initiatives such as 'impact measurement') is generally preferable to a more prescriptive model such as in France. Fund strategies must however be open and transparent to allow individual investors (scheme members) to match their preferences to fund strategies.

Incentivising socially valuable start ups is highly desirable in my view, however I am not convinced that pensions are necessarily the right vehicle for doing this.

This fluidity is now however without its downsides. I would, for example, encourage the Law Commission (and others eg regulators, media) to view data, rankings and ratings with caution as methods vary. Data and related ratings that use CO2 output as a key 'measurable' is an example.

For example, compare these two funds:

i. A fund that invests entirely in well researched financial services companies with a low overall 'carbon footprint'. (ie lots of data available)
ii. A fund that invests significantly in under researched, newer or smaller companies that are developing solutions to complex environmental problems and emitting significant levels of CO2 as part of the manufacturing process.

The latter fund may have the higher carbon footprint (as it is in manufacturing) but would - in many investors' opinions - be delivering a greater 'social benefit' because it is specifically intending to contribute to positive change. As I understand it – the latter may also be further 'marked down' by some as its investee companies may not be known to ratings agencies.

This illustrates that specialist data of this kind needs to be properly presented and understood in order to be helpful when comparing funds and their 'social impacts'.

Incidentally - both funds may be well managed and have strong performance. Neither is necessarily 'right or wrong'. They will however appeal to different people – who may have different opinions. (And may also be different age groups.)

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

- As set out above my view is that individual direct holdings generally present unacceptable risks for DC pension members (particularly in GPPP type schemes).

- This question is not significantly relevant to the SRI/ethical investment fund sector in my view. None of us has a crystal ball - however past performance, research and growing megatrends all indicate that funds with the kinds of strategies listed here are able to deliver acceptable (absolute and relative) performance.

- Increasingly pressing megatrends (such as climate change, resource pressures, labour standards and changing demographics) indicate that bringing 'environmental, social, governance' (and sometimes additional 'ethical') issues into the investment process is increasingly important – particularly for younger investors. As such a failure to consider such issues (alongside other factors) is increasingly viewed as a greater risk than considering such issues.

- The significant resource devoted to 'ESG research' (environmental, social and governance) amongst institutional investors indicates that well informed (professional) investors are aware of this. The fact this is rarely raised with smaller / individual investors is a major market failure.

**Question 7**
**In practical terms, how can financial advisers:**

**(a) best explore their clients' social motivations?**

- This is an area that I have been involved in for many years in a 'specialist' capacity – including training financial advisers. (See attached 'Integrating SRI into the advice process' brochure.)

- This process typically starts with an initial question or brief discussion. This may lead to further fact finding for potentially interested clients.

- In brief (for non specialists) there are two options for further fact finding:
  a) offering a list of ethical issues and strategies from which a client selects their areas of interest or concern
  b) offering indicator statements to help identify the 'SRI Styles' that are interest to them

Advisers typically use one or the other of these. Some use both as a 'styles' based fact find is sometimes insufficiently detailed.

To see examples -

- The free to use online 'SRI StyleFinder' fact find tool is open to all: http://stylefinder-tool.fundecomarket.co.uk/
- Other examples (eg from Synaptics) are available via the sriServices Literature Directory. http://www.sriservices.co.uk/advising-on-sri/adviser-support-literature
  - The above are examples. They are designed to suit different situations and technologies – and to help users select from the whole market. Individual advisers or schemes need to develop their own methods based on their strategies, aims and technology.

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

- My view is that this is a major challenge for financial advisers which is why I have developed the online tools I now offer.
- From experience, I know that many (less experienced) advisers find presenting clients with an extensive list of 'ethical issues' can be problematic. This is because clients tend to select all options - and may also ask complex questions that may be difficult (or perhaps impossible) to answer.
- The result of this has tended to be that advisers who are daunted by this tend to look for ways to direct clients away from ethical funds.
  - This led to the emergence of my database and the 'SRI Styles' model based around 'indicator statement' based fact find method. This system groups

together 'ethically similar' fund options. The number of styles has been kept to a manageable number in order to avoid confusion – and also to ensure there are comparable options with each segment.
    - See below for information on these SRI Styles.
- In general terms the requirements to be clear, fair and not misleading are linke to;
    - Ability to identify the existence of SRI/ethical options
    - A broad understanding of the diversity of this market
    - The availability of fund specific 'ethical' information
    - The ability to focus on key issues of interest to individual investors (ie don't allow individuals to be confused by too much choice or detail)
    - The ability to compare core SRI/ethical fund strategies (ie not grouping them all together in a homogenous mass)
    - Use of terminology that people can understand (with further explanations available)
    - Not overstating what funds do or do not do (few things are black and white in this area as issues are complex)
    - Remembering that these are investments and that compromise may/will be necessary (eg investing 100% in clean energy or social projects will probably be financially inappropriate)
    - Objectivity - understanding that different people have different views and funds have different strategies (as aims and opinions vary)
    - (See sriServices Top Tips directory for further suggestions)

In practice advisers, product providers and scheme trustees need to craft processes that meet the needs of their clients' needs and works with the way they operate. (For example – there is no benefit implying that all possible combinations of all ethical, social and environmental issues are available if only one or two options are available.)

I would be happy to discuss this area further if helpful.

**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?**

Based on over 20 years of specialist experience in this area I would urge caution in this area.

My view is that done poorly giving this area a single 'label' this would be a disaster – and that doing this well would be difficult.

This risks reducing welcome and necessary innovation, risk confusing clients, fuelling distrust and leading to poor decision making.

However – I also recognise that greater clarity may be welcome and that in general terminology is a challenge for the sector. This is in part because some terms originated in the institution market, whereas others came from the retail - individual investor - market.

- My view therefore is that any overarching 'label' should make it clear that the area encompasses **'Any option that takes ethical, social and environmental issue into account to a significant extent'**...

- And that subheadings / further segmentation – along the lines of the Fund EcoMarket classifications – would be essential in order to explain fund options are support diversity (of both fund manager strategy and client opinions).

The terms that are currently used such as 'ethical' or 'social' all have advantages and disadvantages. These are born of a long history and also change on occasions as ethical, social and environmental challenges shift (which is particularly relevant to individual investors and longer term scheme members). A failure to recognise this can confuse and mislead.

Although often unpopular acronyms are often the least misleading, least emotionally loaded and most potentially precise ways of describing this market – but only work if accompanied by additional explanation.

- The classifications used with the 'SRI Styles' options on the 'whole of market' www.FundEcoMarket.co.uk tool and hub are below.
- These were designed to reflect what is actually available in the UK today. Feedback has been positive. (Two or three have changed since they were developed a few years ago as fund options have changed.)
- Fund EcoMarket was awarded 'highly commended' (runner up) in the Corporation of London Sustainable City Awards 2015 – 'Sustainable Finance' category, in the year it was launched

**Fund EcoMarket SRI Fund classifications:**

- **Ethically Balanced** funds combine a wide range of positive and negative ethical screening policies as part of their investment strategies and may apply 'best in sector' strategies.
- **Negative Ethical** funds use clear, sometimes strict and extensive, negative 'ethical' screens as their core strategy. They may avoid a significant number of areas on ethical grounds (eg armaments, tobacco, gambling) or may focus on a smaller number of areas.
- **Sustainability Themed** funds focus on sustainability related issues and opportunities as part of their investment strategy, often alongside ethical criteria.
- **Environmental Themed** funds significantly integrate environmental issues into their investment strategies, sometimes alongside ethical avoidance criteria – sometimes with a focus on 'solutions' companies.
- **Social Themed** funds focus on 'people issues' (such as employment and basic necessities of life) and assess societal benefits as well as financial return.
- **Faith Based** investments invest in line with specific religious principles (eg Shariah Law)

**Fund EcoMarket 'corporate level activity' classifications** (ie activity that relates to non screened and themed funds)

- **ESG Integration** is a 'corporate level' strategy whereby some fund managers consider Environmental, Social and Governance issues as part of their regular investment analysis for all funds.
- **Responsible Ownership** is a 'corporate level' strategy whereby some fund managers use their position as investors to encourage the companies they invest in to raise their standards across key environmental, social, governance or other issues.

- These categories are explained in the 'Help' area of Fund EcoMarket
- My recent CII Thinkpiece covers **'SRI: environmentally, socially and financially useful, and uniquely placed to help build trust'** explains this further.
- Fund EcoMarket is free to use and launched with the sole intention of helping to explain this area in order to encourage its success and direct greater investment towards more 'positive' companies.
- Fund specific 'ethical' information is within OEIC fund entries only at present (Pensions users need to read across to these entries.)

- All funds are listed and fund providers can enter information free of charge.
- The tool is sponsored by Alliance Trust Investments, Rathbones, Sarasin & Partners, Pictet, Quilter Cheviot, Unicorn Asset Management. (Sponsors' funds are highlighted.)

**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?**
N/A

**Attached**

- List of all UK regulated retail pension funds as shown on Fund EcoMarket
- '5 step process' guide

Law Commission
Reforming the law

**THE LAW COMMISSION**

**PENSION FUNDS AND SOCIAL INVESTMENT**

This optional response form is provided for consultees' convenience in responding to our call for evidence on pension funds and social investment.

The response form includes the text of the questions in the call for evidence, with boxes for yes / no answers (please delete as appropriate) and space for comments. You do not have to respond to every question. Comments are not limited in length (the box will expand, if necessary, as you type).

Each question gives a reference in brackets to the paragraph of the call for evidence at which the question is asked. Please consider the surrounding discussion before responding.

We invite responses from 7 November 2016 until **15 December 2016**.

Please return this form:

By email to: commercialandcommon@lawcommission.gsi.gov.uk.

By post to: Lucinda Cunningham, Commercial and Common Law Team,
Law Commission, 1st Floor Tower,
Post Point 1.53, 52 Queen Anne's
Gate, London SW1H 9AG

We are happy to accept responses in any form. However, we would prefer, if possible, to receive emails attaching this pre-prepared response form.

| **Freedom of information statement** |
|---|
| Any information you give to us will be subject to the Freedom of Information Act 2000, which means that we must normally disclose it to those who ask for it.<br>If you wish your information to be confidential, please tell us why you regard the information as confidential. On a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not be regarded as binding on the Law Commission.<br>***The Law Commission processes personal data in accordance with the Data Protection Act 1998 and in most circumstances it will not be disclosed to third parties.*** |

**YOUR DETAILS**

| Name: | |
|---|---|
| Organisation: | Sainsbury Family Charitable Trust |
| Role: | |
| Postal address: | |
| Telephone: | |
| Email: | |

**CONFIDENTIALITY**

Do you wish to keep this response confidential?

| Yes: | No: NO |
|---|---|

| If yes, please give reasons: |
| --- |
| |

**QUESTION 1: BARRIERS TO PENSION FUND INVESTMENT**

(Call for evidence, paragraph 1.15)

What are the barriers to pension funds investing:

(a) In infrastructure generally?

(b) In socially significant infrastructure?

(c) In other forms of social investments?

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**QUESTION 2: LEGAL AND REGULATORY BARRIERS**

(Call for evidence, paragraph 1.15)

Do any of those barriers (identified in Question 1) relate to issues of law and regulation?

| Yes: | No: | Other: |
| --- | --- | --- |

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|---|
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**QUESTION 3: SIZE OF PENSION FUNDS**

(Call for evidence, paragraph 1.15)

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

| Yes: | No: | Other: |
|---|---|---|
| | | |

**QUESTION 4: ETHICAL PENSION OPTIONS**

(Call for evidence, paragraph 1.18)

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?

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**QUESTION 5: PENSION SAVER ENGAGEMENT**

(Call for evidence, paragraph 1.18)

We seek views about how far these options (identified in Question 4) 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?

| Yes: | No: | Other: |
|---|---|---|
|  |  |  |

**QUESTION 6: RETURNS FOR SOCIAL INVESTMENT**

(Call for evidence, paragraph 1.18)

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?

| Yes: | No: | Other: |
| --- | --- | --- |
| | | |

### QUESTION 7: FINANCIAL ADVISORS AND SUITABILITY

(Call for evidence, paragraph 1.22)

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?

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### QUESTION 8: LABELLING SOCIAL INVESTMENT OPTIONS

(Call for evidence, paragraph 1.23)

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?

| Yes: | No: | Other: |
|---|---|---|
| | | |

**QUESTION 10: LAW OF SOCIAL ENTERPRISES**

(Call for evidence, paragraph 1.25)

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?

| Yes: | No: | Other: |
|---|---|---|
| | | |

**FURTHER COMMENTS:**

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.

We represent a network of foundations, asset managers and NGOs who campaign for investors, including pension funds, to divest from fossil fuels and invest in clean technologies (the Divest Invest movement http://divestinvest.org/europe/ )

We would like to draw attention to the following recent reports which significantly shape the social, legal and financial framework for social investment funds:

1. Shifting social norms.

Divestment is a mainstream strategy for investors. The Global Fossil Fuel Divestment and Clean Energy Investment Movement – December 2016. This report was released on 12th December showing the latest figures of divested assets globally is now over $5trillion.

https://www.arabellaadvisors.com/wp-content/uploads/2016/12/Global_Divestment_Report_2016.pdf

2. The legal landscape is shifting.

2a. Christopher McCall QC Legal Opinion on fiduciary duty: A wide range of different charities may be legally required to re-evaluate their approach to carbon intensive investments

http://www.bwbllp.com/knowledge/2015/11/25/bwb-instructs-christopher-mccall-qc-on-ethically-questionable-investments/

2b. European Commission revision of IORP Directive to ensure pension trustees consider climate risk.

http://ec.europa.eu/finance/pensions/iorp/index_en.htm

3. Shifting financial norms. An academic study by Warwick Business School funded by Newton Investment Management in early 2016 has shown that removing investments in fossil fuels historically has not had a negative impact on portfolio performance

http://www.newton.co.uk/global/file/2degrees-the-impact-of-ethical-investing/

21 December 2016

Tamara Goriely
Law Commission
1st Floor, Tower
52 Queen Anne's Gate
London SW1H 9AG

Dear Ms Goriely,

I am writing in my capacity as Chief Executive of the UK Sustainable Investment and Finance Association in relation to the recent Law Commission call for evidence on pension funds and social investment. We appreciate you taking the time to meet us and a selection of our members to discuss our views in addition to our written evidence.

The UK Sustainable Investment and Finance Association (UKSIF) is the membership network for sustainable and responsible financial services in the UK. We act as the voice of the SRI sector and promote long-term investment aimed at sustainable economic development, enhancing quality of life and safeguarding the environment. Our members include many of the UK's largest pension funds, banks, insurance firms and asset managers, all of whom are committed to long-term sustainable economic growth.

**Question 1**

**What are the barriers to pension funds investing:**

**(a) In infrastructure generally?**

Increasingly, infrastructure investment has become an attractive proposition to pension schemes, enabling them to diversify their portfolio and match long-term liabilities. There are a variety of obstacles to pension schemes making these investments, however. One UKSIF member described infrastructure as an appealing asset class provided exposure was "cheap and relatively easy" but went on to say that since this is rarely the case, most defined-contribution (DC) schemes would be better suited to core, central asset classes such as equities, fixed income and property. As with defined-benefit (DB) schemes, often only the biggest funds are able to invest.

A lack of experience in infrastructure investment on trustee boards may also represent a significant obstacle, and one which may be compounded by the small size of some funds. Even where there is some exposure, it is often so small that schemes simply cannot justify creating an internal capability to invest directly or develop internal resources. Difficulties for pension schemes investing in infrastructure were confirmed by UKSIF members at a meeting with MPs in 2015 at which they made clear it was easier to invest in infrastructure assets in Australia than it was in the UK. To illustrate the contrast between regimes, UK pension scheme exposure to infrastructure currently stands at around 1%, compared to the situation for funds in Australia which has 8-15% of funds invested in infrastructure assets.[1] The Pensions Infrastructure Platform, set up to address this and other issues has been slower than anticipated at raising funds and has yet to meet its £2bn target. If successful, however, it will allow member schemes to achieve the benefits of scale which characterise the asset class.

[1] http://researchbriefings.files.parliament.uk/documents/SN06594/SN06594.pdf

Infrastructure is an inherently illiquid asset class which presents its own problems, particularly in the DC space. This is chiefly due to daily liquidity and daily pricing practices on assets in the fund. This "daily dealing" means DB funds are in a far better position to invest in infrastructure and prevents many DC schemes from investing in the many available funds already in the market. To overcome this problem, some infrastructure funds have started to be "wrapped" in more liquid funds to provide both liquidity and a daily price, however this again tends to be the preserve only of larger schemes. DC schemes are in theory well placed to earn the illiquidity premium generated by such assets given their long-term time horizons: there is no reason why a saver in her early 20s would require even infrequent access to her assets. The position has been described by one UKSIF member as a "nonsense".

The DC Investment Forum (DCIF) made clear that there is no regulatory requirement for daily dealing and that it was instead a result of the evolution of the DC market. In particular it has developed as a market norm for platforms which require daily priced funds to meet the consequences of members switching, retiring and dying on different dates. DC schemes were designed to be flexible savings vehicles to allow these members to easily and regularly transfer in and out of funds. However these needs have evolved since the rules on daily dealing were established and will continue to do so due to automatic enrolment. DC members are currently at a significant disadvantage since they are denied the benefits of diversification and the illiquidity premium received by DB members. The focus should now be to encourage long-term default investment options for DC members, including by investing in more illiquid assets.[2] This is an area the Law Commission should investigate further.

**(b) In socially significant infrastructure?**

Provided returns are satisfactory we see no further barriers to DC pension funds investing in socially significant infrastructure, subject to the above.

**(c) In other forms of social investments?**

Since social investments also tend to be illiquid, the issues around daily dealing will apply. The Law Commission's 2014 report into fiduciary duties was helpful in clarifying that the law permits pension scheme trustees to take non-financial factors into account providing they have good reason to think members would share that view and that there is no risk of significant financial detriment to the fund. The report recommended the use of the terms *financially material factors* and *non-financial factors* rather than *ESG* and *ethical* to help clarify the law for trustees. We do not think this language has permeated the sector yet, and in part this was due to the failure of DWP to make the recommended changes to the Investment Regulations in 2015. We have also expressed our concern to you that the Law Commission's own language has not been used in this follow-up consultation.

Another obstacle is the scale of the universe of investible assets. UKSIF member feedback was that one way around this may be to broaden the definition of what a social investment is. Social Investment has its roots in the charitable space and the market has developed to cater for those investors; currently the market has neither the size nor demand to match the need of pension schemes. Big Society Capital has identified three potential groups of high impact assets that a social investment fund may be able to invest in:[3]

- Social investments (traditionally smaller investment sizes)
- Larger investments into the social sector (large organisations with defined social purpose)

[2] DC Investment Forum, *Mind the Gap: The case for a relaxation of daily dealing requirements for DC pension funds*, 2013
[3] http://www.bigsocietycapital.com/sites/default/files/Social%20pensions_Technical%20paper_Oct16.pdf

- Investments for broader public purpose (by organisations not within social sector, but intending to deliver a social impact, such as public institutions)

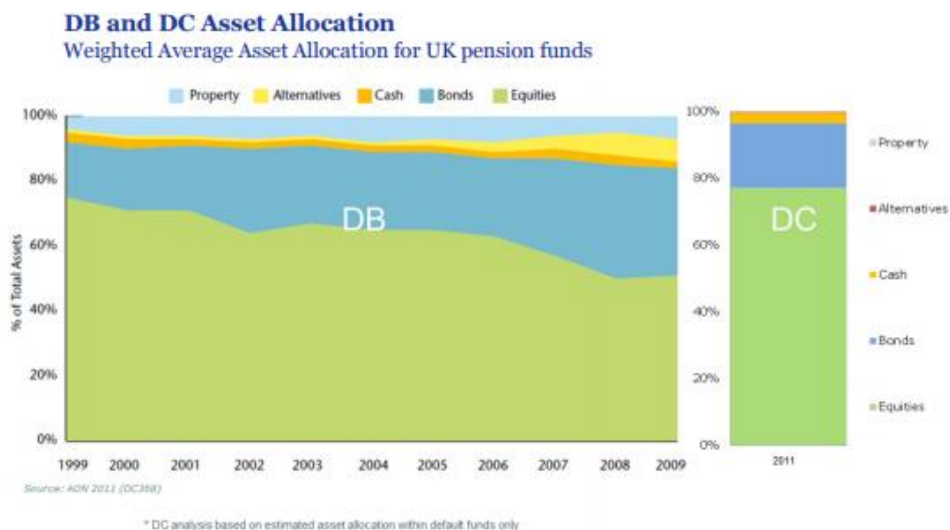
If the definition is to be broadened, it will be essential for the focus to remain on the social aspect of those broader opportunities. For investors this will mean a requirement for information on social outputs to be available to members of the fund which may in itself help drive engagement and further saving.

**Question 2**

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

We have already discussed in some detail the issues surrounding daily dealing and highlighted that this is having a definite impact despite not being a regulatory issue. The failure of DWP to implement the Law Commission's recommended changes to the Investment Regulations has prolonged the confusion for some trustees over their fiduciary duties. We hope the recent change to the investment guidance for trustees by TPR will in part address this, and also the transposition of IORPs2 into UK law.

One key barrier to social investment by pension schemes that has been highlighted to us by UKSIF members on several occasions is that it is very expensive to deliver given the 75bps cap on default funds. Although the cap does not apply to chosen funds, we have heard that it tends to apply in practice anyway. Given the tiny size of the majority of these funds, there would be little impact in boosting social investment unless default funds were targeted. In fact, we hear from members that the 75bps cap, despite being introduced to ensure trustees and fund managers act in the best interests of members, has forced more schemes to invest in cheap passive equity funds. This has meant less balanced portfolios in DC schemes which are dominated by equities. The 2013 DCIF report illustrates this point with an asset allocation comparison showing that DC schemes have much larger equity weightings than their DB counterparts and far less diversification overall.




Now whilst there are other relevant factors in that comparison, such as the age of the investors, it is significant that the DCIF feels able to argue that as much as 35bps of DC performance could be gained from illiquid investments, producing 5% larger pots. A 'focus on fees rather than value' has

acted as an obstacle to DC schemes gaining access to the benefits of diversification.[4]

We have also heard from members that the recent update to permitted links rules has acted as an unexpected barrier to schemes using fund platforms. The result has been a regulatory inconsistency whereby we are informed DC trustees are classified as retail investors. The FSA increased protections for DC scheme members, which included a list of appropriate assets; the feedback we have received is that this has acted as an obstacle to innovation.[5] In its response to a public consultation it argued that there was not a 'pressing need or consumer demand' to expand their definition further. This approach has made it very difficult for a DC scheme using a fund platform to invest in e.g. an alternatives only pooled fund. We think given the Government's focus on social investment and our own polling which reflects significant consumer demand, this could be an opportunity to revisit the FCA's approach in this area.

**Question 3**

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

A small fund has less flexibility to deal with the practical consequences of issues such as liquidity, daily pricing and permitted links.

Most DC money goes into default funds and the focus should therefore be on rules permitting default funds to do social investment. More generally, most DC schemes tend to be smaller in comparison to DB, but assets under management will continue to grow as more people are automatically enrolled. DWP statistics show that by 2018 there will be an extra 9 million savers due to automatic enrolment, while The Social Market Foundation estimates DC assets under management to grow to £600bn by 2030.[6]

We are not experts on the legal practicalities of scheme mergers, however it is our understanding that the most important consideration are a scheme's own rules. Most have relatively broad rules allowing them to transfer and receive, while for those which do not there is a relatively straight forward process of amending the scheme's rules. UKSIF member feedback is that in most cases, particularly where a merger may impact costs, actuarial sign off will be necessary. This is to show that the benefits to be received by members are on the whole no less favourable than those they are entitled to in the current scheme – for some schemes this may be a barrier.[7]

**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?**

Key terms relating to sustainable and responsible investment are as crucial to understanding as they are difficult to define due to predetermined perceptions of investments and differing methodologies

[4] DC Investment Forum, *Mind the Gap: The case for a relaxation of daily dealing requirements for DC pension funds*, 2013
[5] FSA Feedback Statement FS12/2 available at https://www.fca.org.uk/publication/feedback/fs12-02.pdf
[6] Social Market Foundation and Big Society Capital, *Good Pensions: Introducing social pension funds to the UK*, 2015 available at http://www.smf.co.uk/wp-content/uploads/2015/09/Social-Market-FoundationSMF-BSC-030915-Good-Pensions-Introducing-social-pension-funds-to-the-UK-FINAL.pdf
[7] More information available at https://www.sackers.com/pension/merger-basics/

in “non-traditional funds”. This is one reason the Law Commission in its 2014 report opted to recommend the use of *financially material factors* and *non-financial factors*.

In precise answer to your question, there is a large number of funds that are “ethical” and use the term in their names. A list of these funds are available at YourEthicalMoney.org and FundEcoMarket.co.uk.

But in addition to an “ethical” approach these funds- and an increasing number of mainstream funds- will use additional techniques and approaches, the most common being sustainability themed, positive and negative screening, and best in class. Over time savers and investors have become less concerned about excluding certain sectors and more interested in the role of businesses in society and how they can help bring about positive social outcomes. This process has given rise to a wide spectrum of approaches with “ethical” being an important subset in terms of size and intellectual leadership. Purely “ethical” approaches are now probably a minority in a fast-growing sector characterised by the integration of financially material ESG factors. We consider funds practising responsible investment as likely to engage in ongoing active ownership with investee companies on these types of issues. This is becoming an increasingly mainstream approach to investment and an example is the NEST default fund which operates in this manner.

Both of the above approaches form part of sustainable and responsible investment, which could be summarised as any type of investment strategy that incorporates consideration of ESG factors, financially material or otherwise. Logically therefore, social investment may be included in this description. Further, if social investment can be structured appropriately and the return profile is suitable then it is no longer a “non-financial” factor or an “ethical” issue, but can form part of a risk diversification strategy and is therefore a financially material consideration. We are in favour of this direction of travel, but would again highlight the issues surrounding daily dealing and the 75bps cap.

**(b) What proportion of people take them up?**

Take up of ethical options has generally been low and NEST estimates enrolment into its ethical fund to be 1%. As we have mentioned, given the fact ESG is incorporated in its default fund, this figure may not be entirely revealing. Many people whose values might normally lead them to enrol in the ethical option may not choose to do so since these concerns may have already been catered for in the default fund. NEST also produces excellent communications for members including an annual report which details its responsible investment and stewardship activity.

According to the Investment Association ethical funds total £12.1billion and are 1.2% of the total. The IA tracks monthly sales and for the past two years or so the share of ethical fund sales has been appreciably higher at 3-4%. Further, polling commissioned for Good Money Week 2015 showed that 54% of people with investments want their pensions or savings to have some positive impact on the world beyond just making money.

Our view is that the appetite for responsible investment, which would include social investment, among UK savers is higher than it has been and is likely to grow further.

**(c) What sort of returns do they provide?**

Both responsible investment funds, i.e. those which integrate ESG factors and ethical funds can outperform more traditional, mainstream funds. Evidence is readily available that ESG considerations boost operational performance of companies as well as stock price as outlined in a

report last year from an UKSIF member.[8] One clear example of this happening in practice is the FTSE4Good Index which has, for the past five years, outperformed both the FTSE All Share and the MSCI World indices, while over half of ethical equity funds have outperformed the FTSE All Share for the past 10 years.[9] In your work on fiduciary duty you also cited academic research which support the case for responsible investment.

**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?**

UKSIF member feedback suggests there are three layers of offer by employers in a DC range: the default fund, where the majority of savers will be enrolled; a relatively small number of prompted extra funds, or chosen funds; and in some cases, the full range of funds offered by a DC platform. We have been told that while options are important in promoting greater engagement with pension saving, too many options can have the opposite effect.

Despite the risk that fund proliferation will affect engagement we do face the situation where as our polling shows some people want to create a positive social or environmental outcome and a return, and funds offering that are not offered. This is linked to the lack of financial literacy among the majority of savers. We think efforts to increase awareness more generally of the £1.5tn SRI market in the UK would be helpful. In our polling despite 54% wanting their investments to have a positive impact, 54% of people were unaware that sustainable and ethical products exist, which rises to 63% of millennials- the group most impacted by automatic enrolment.

More fundamentally, levels of pension engagement in the UK have been low for decades. One reason has been a general reliance on the state safety net and "guaranteed" DB pensions. The financial crisis resulted in a need to move away from this system, a further shrinking of the state and a transition to DC pensions whereby all investment risk lies with savers. Although efforts have been made to improve financial literacy, such as the introduction of the subject to the secondary school curriculum in 2014, not enough has been done. The introduction of automatic enrolment represents a move to bypass the lack of literacy and engagement amongst savers rather than address it. This was a short-term fix, and policy makers have yet to address the inadequacy of savings for retirement. A resulting drop in confidence levels of automatic enrolment could lead to increased opt-out rates and ultimately less capital with which to do social investment. It is absolutely critical to address the long-term problem of a lack of financial literacy and UKSIF members have been calling for efforts to boost financial education.[10] This would be hugely beneficial and far more effective at driving pension saving and engagement than an increase in the number of options for a generally financially-illiterate customer base.

We would urge consideration of the idea of regulation forcing the offering of a responsible default option. This would not boost the number of funds offered materially and would give some profile to the issues under consideration here.

[8] Arabesque Partners and University of Oxford, *From the stockholder to the stakeholder*, 2015 http://www.arabesque.com/index.php?tt_down=51e2de00a30f88872897824d3e211b11

[9] SALWAY, J. (5 November 2016), *Does it pay dividends to be an ethics man?*, The Scotsman Online http://www.scotsman.com/news/opinion/jeff-salway-does-it-pay-dividends-to-be-an-ethics-man-1-4278511

[10] For example Aviva's Sustainable Capital Markets Union Manifesto, available at https://www.aviva.com/media/upload/SCMU_Manifesto.pdf

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

We think options which seek a social impact as well as a financial return would encourage engagement, but communication and reporting to scheme members on social outputs is crucial. Our polling for Good Money Week 2016 has shown that 47% of people with an investment would be interested in annual update on their social and environmental impact. This figure rises to 58% of people under the age of 35.

**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**?

There are ample opportunities for savers wishing to invest in a product that has both a positive social or environmental impact and makes a return. There are various SRI and ethical funds on offer which can achieve this and it remains important that 'social investment' isn't defined too narrowly. On investible assets that are specifically designed for social investment, we would point to recent research by Big Society Capital. It answers this question in detail and concludes that there are at least £67.4bn of social investment assets suitable for pension fund investment in the UK.[11]

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

We do not accept the premise of this question. As UKSIF member feedback and the BSC report both make clear, social investment does not necessarily require a financial sacrifice and there are a number of social investments that target market rates. These are likely to be far more attractive to pension schemes which, unlike endowments for example, would find it harder to move away from benchmarks due to their liabilities. It may also be noteworthy that UKSIF polling showed that 60% of the public believes the financial sector can make high returns while investing ethically and responsibly. What is crucial to the growth of the market is to continue to gather information on the financial and social return profiles of these funds. For social investment we hear that there is a range of financial returns available, from a 95% payback to a 4% return. It is possible that trustees of schemes offering a social investment fund which is clearly below market rate or likely to result in a loss for savers might be considered by the courts to have failed in their fiduciary duty. This is why it is essential to both report on the fund's performance as well as to have an evaluation framework for the social outcomes of the fund with clear information on how it helps to establish social change.

**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?**

[11] Big Society Capital, *Designing a social investment fund for UK pensions,* 2016 https://www.bigsocietycapital.com/sites/default/files/attachments/Designing%20a%20Social%20Investment%20Fund%20for%20UK%20pensions.pdf

Following discussion with the Law Commission we understand this question is not a priority and likely to receive less focus than other issues highlighted in the consultation paper. Nonetheless we highlight our response to the FCA on the regulatory barriers to social investment by retail clients which identifies a range of issues that must be addressed to help the market grow.[12] Further, polling commissioned for Good Money Week 2016 shows that 69% of people support a new law requiring financial advisors to ask customers if they would like to exclude specific sectors or companies.

**Question 9**

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

Polling for Good Money Week 2016 also showed an overwhelming desire amongst the public for the introduction of a kitemark-style label. It showed that 63% of people backed a label to identify ethical or sustainable financial products, with 43% saying it would make them more likely to buy a financial product, a number which rose to 53% of 18-24 year olds. We hear from Eurosif that there is now demand from policy makers in the European Parliament and Commission for clear definitions on the different types of sustainable and responsible investments to enable them to better understand the concepts involved in e.g. the PRIIPs Directive and IORPS 2. Meanwhile, throughout Europe more countries are developing their own approaches to definitions and labels including in Belgium, France, Austria, Germany, Switzerland and Luxembourg. It is to be noted that these moves are from savers and from regulators.

Traditionally the SRI sector in the UK, typified by the UKSIF membership and composed of "providers", has tended to shy away from definitions and standards due to the potential to stifle innovation. We have taken soundings and still believe that there is no consensus support for a rigid definition of SRI investment styles at this moment. UKSIF members raised some practical considerations for the introduction of any such label, with sample comments saying that too "strict" a label might place such stringent requirements on funds that it would be almost impossible to achieve, whilst a "weak" definition might result in a 'race to the bottom' and box-ticking, whereby funds only meet the bare minimum requirements in order to maintain their possession of the label. In addition there is a widespread view that the UK should seek to align any definitions with international work. At the moment there is no consensus on what should be done, but a consciousness that the issue is "live".

As part of work examining how finance can support the Sustainable Development Goals, Aviva has made a public call for a general SRI kitemark-style label or standard for institutional investors.[13] This would assess how well fund managers integrate ESG issues into their investment analysis, engagement and AGM voting.

Feedback from UKSIF members that specialise in social investment has been to support a specific social investment standard (i.e. not a more general SRI standard), but with some provisos:

- The standard is clear that, unlike other approaches in the SRI sector, the primary activity of the investment is to deliver social value.

[12] Available at http://uksif.org/wp-content/uploads/2016/03/UKSIF-response-to-FCA-regulatory-barriers-to-social-investment.pdf
[13] Aviva, *Money Talks: How finance can further the SDGs*, 2016, available at http://www.aviva.com/media/thought-leadership/money-talks-how-finance-can-further-sustainable-development-goal/

- The introduction of such a standard must include a clear reporting framework to evaluate and communicate the social impact of the fund.
- The fund is one part of the wider investment chain – there are many others which will be impacted i.e. asset owners, individual investors, fund managers, social enterprises and stakeholders. This must be the context in which any standard is framed.
- Innovation in social investment must not be stifled. A triennial review of the social investment sector following the introduction would be welcome to ensure the standard is flexible enough to encourage innovation – this cannot be a race to the bottom.

To be clear, we believe our members would support the introduction of a description in respect of social investment but that there is not currently a consensus as to the efficacy of that approach in responsible investment more widely.

**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**?

We are not expert enough to answer this question fully, however we do flag the impact Brexit will have on social enterprises if EU benefits which currently flow to the sector are not recycled, at least in part. Social enterprises in the UK will no longer have access to the benefits arising from e.g. the Social Business Initiative and we would welcome a review into the impact this, and other impacts following Brexit, will have on the sector and what steps the Government can take to mitigate any risks which result from it.

Yours sincerely,

**Simon Howard**
Chief Executive
UK Sustainable Investment and Finance Association (UKSIF)

PRI Principles for Responsible Investment

# LAW COMMISSION: DEFINED CONTRIBUTION PENSION FUNDS AND SOCIAL INVESTMENT

## SUMMARY OF PRI'S RESPONSE

We welcome the Law Commission revisiting the issue of fiduciary duties applicable to pension schemes, following the Commission's report *The Fiduciary Duties of Investment Intermediaries* in 2014.

The consultation references the FCA's definition of Social Investing: *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.* We agree with this definition, though note that it encompasses a very wide range of investment approaches, including those seeking positive impact alongside competitive returns. It is necessary to clearly differentiate between investments seeking to sacrifice financial return for social impact and those seeking positive social impact alongside competitive financial returns. There is no impediment in principle to positive social impact flowing from prudent, return maximising investment activities.

As the Commission confirmed in its 2014 report "there is no impediment to trustees taking account of environmental, social or governance factors where they are, or may be, financially material"[1]. It is not the origin of the factor, but rather its financial materiality which is of relevance[2]. As such, all UK pension scheme assets should use investment processes and decision-making that integrate material Environmental, Social and Governance (ESG) factors.

Defined Contribution (DC) funds with social impact objectives is a novel proposal and we welcome innovation in this area. For funds seeking social impact to the detriment of financial returns, we consider there to be more flexibility in Chosen Funds as opposed to Default Funds, provided that appropriate advice is given to beneficiaries. For contract-based schemes, we also recommend enhancing the remit of Independent Governance Committees to include an assessment of long-term value creation, product suitability and engagement practices (in addition to the current value for money test, which is fee-focused).

Throughout this response, we note practical and legal challenges faced by funds considering ESG issues, irrespective of the expected financial implications. We highlight one for the Commission's particular attention – the absence of clear guidance on determining 'significant financial detriment'. In our experience, this causes Trustees to be excessively conservative in their approach.

[1] Fiduciary Duties of Investment Intermediaries, UK Law Commission 2014

[2] The evaluation of financial materiality is at the well-reasoned discretion of pension scheme trustees having taken appropriate advice.

## YOUR DETAILS

| Name: | |
|---|---|
| Organisation: | Principles for Responsible Investment |
| Role: | |
| Postal address: | |
| Telephone: | |
| Email: | |

### CONFIDENTIALITY

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|---|---|
| If yes, please give reasons: | |

### QUESTION 1: BARRIERS TO PENSION FUND INVESTMENT

(Call for evidence, paragraph 1.15)

What are the barriers to pension funds investing:

(a) In infrastructure generally?

(b) In socially significant infrastructure?

(c) In other forms of social investments?

(a) Infrastructure and (b) socially significant infrastructure

Short-term investment horizons have often caused under-investment in infrastructure. ESG analysis can be part of the antidote to investment short-termism by helping to re-orient investors and investee companies towards long-term investment horizons. Many ESG factors are of long-term relevance to sustainable corporate performance and resilient business-models. Through enabling an understanding of a company's business model, its dependencies

and vulnerabilities, ESG analysis can assist in an understanding of the long-term sustainability of existing financial performance.

Infrastructure investment can take the form of listed or private equity or debt securities. Many DC savers will have some exposure to listed infrastructure companies but few will be able to invest directly in underlying assets. For this response, we focus on barriers to DC savers investing directly in private assets.

- **Liability mismatch/time horizon**

Infrastructure projects can, in theory, provide a good match for the long-term liabilities of pension funds. However, their application to DC funds is not straightforward.

DC savers are particularly attuned to the short-term performance of their savings. When selecting from the fund range, they are presented with the fund's short-term past performance – a poor heuristic for judging future performance.

DC funds often offer same-day mark to market valuation. This reorients savers towards short term performance and imposes restrictions on investing in long-dated assets[3]. When investing in private assets, the funds may not be drawn down immediately and the investment may only generate returns after the initial construction phase.

Finally, DC funds require relatively high levels of liquidity. DC savers have the ability to transfer between funds and to transfer their pension benefits accrued with one employer to another scheme. There may not be an easily accessible secondary market for private assets.

- **Suitability and pipeline**

Investors will typically have a minimum transaction size which some infrastructure projects do not meet. In our experience, there is currently a lack of investable projects and project pipelines are not transparent. This results in many investors bidding for a small number of projects which drives up prices, exacerbated by slow project development and decision-making.

- **Skills and capacity**

Specific expertise is required to manage the risks across the time period of the investment. Infrastructure investments may have high transaction costs, high due diligence requirements and be subject to risks such as regulatory uncertainty.

Trustees may not feel confident identifying fund managers with the appropriate skills, or consider the additional due diligence required to be disproportionate to the benefit.

Corporate plan sponsors are subject to many of the same constraints, but have no ongoing role in monitoring contract-based schemes. Corporate plan sponsors are therefore unlikely to demand that providers of contract-based DC schemes provide the option to invest in infrastructure. Independent Governance Committees (IGCs) have a relatively narrow remit,

[3] In 2016, Partners Group (a PRI signatory) launched a private assets fund with same day pricing for DC clients. This was advertised as a first of its kind. This suggests that the challenges listed are substantial but not insurmountable.



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focussing on value for money. We welcome the introduction of IGCs, but propose their remit be widened (see Q 6).

(c) other forms of social investments.

We elaborate further on fiduciary duties and social investment in Q2.

As with infrastructure, the core issues of skill, suitability and pipeline are pertinent. Investors will seek to satisfy themselves that the investment team has specific investment expertise, a demonstrable track record and clear commitment to both the financial and social objectives of the fund.

Some innovative social investments do not meet minimum transaction sizes for larger funds, and returns may not be sufficient. While some opportunities offer market rate returns, others target market rate returns without a proven business model, or target below market returns.

## QUESTION 2: LEGAL AND REGULATORY BARRIERS

(Call for evidence, paragraph 1.15)

Do any of those barriers (identified in Question 1) relate to issues of law and regulation?

| **Yes:** | No: | Other: |
|---|---|---|

The consultation uses the FCA's definition of Social Investing: *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*. We agree with this definition, though note that it encompasses a very wide range of investment approaches, including those seeking both positive impact and competitive returns (see figure 1). It is necessary to clearly differentiate between investments seeking to sacrifice financial return for social impact and those seeking a combination of social impact and competitive financial returns.

Financial-only
Responsible
Sustainable
Impact
Impact-only
Delivering competitive financial returns
Mitigating Environmental, Social and Governance risks
Pursuing Environmental, Social and Governance opportunities
Focusing on measurable high-impact solutions
Limited or no regard for environmental, social or governance (ESG) practices
Mitigate risky ESG practices in order to protect value
Adopt progressive environmental, social and governance (ESG) practices that may enhance value
Address societal or environmental challenges that generate competitive financial returns for investors
Address societal challenges which *may* generate competitive financial returns for investors
Address societal challenges that require a below-market financial return for investors
Address societal challenges that cannot generate a financial return for investors

*Figure 1 Spectrum of impact and financial return. Source: Bridges Ventures.*

The law distinguishes between "financial" and "non-financial" factors. Environmental, Social and Governance issues can be either.


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| Where an issue is deemed ‘non-financial’, Trustees must ensure that:<br><br>(1) they have good reason to think that scheme members share the concern; and<br><br>(2) there is no risk of significant financial detriment to the fund.<br><br>While there is considerable flexibility for chosen funds to sacrifice returns for social impact, the bipartite test presents obstacles for default funds wishing to do the same. We note:<br><br>■ Absence of expressed preference: In the absence of the beneficiary community having a very clearly defined ethical disposition in relation to a particular issue (such as being employees of an anti-smoking charity), it is very hard for a trustee to reach a conclusion as to the disposition of the beneficiaries as a whole.<br><br>■ Equivalence in investments: As noted above, valuing innovative social investment approaches is difficult. It may be hard for a trustee to form a view as to whether the a Social Investment may be pursued in the absence of material financial detriment, which is tested by reference against an equivalent investment opportunity. In the absence of clear guidance on what constitutes ‘material financial detriment’, many Trustees will be extremely conservative.<br><br>However, where an ESG issue is pursued purely for financial return, the above test should not apply. As the Commission confirmed in its 2014 report “there is no impediment to trustees taking account of environmental, social or governance factors where they are, or may be, financially material”[4]. It is not the origin of the factor, but rather its financial materiality which is of relevance[5]. As such, all UK pension scheme assets should use investment processes and decision-making that integrate material Environmental, Social and Governance (ESG) factors. |
|---|

## QUESTION 3: SIZE OF PENSION FUNDS

(Call for evidence, paragraph 1.15)

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

| **Yes:** | No: | Other: |
|---|---|---|
| The UK has a fragmented pensions market. According to 2015 research, there are just under 220,000 workplace pension schemes in the UK, compared to just 4,300 across the whole of the Netherlands, Switzerland, Germany, Denmark, Sweden, Italy and Norway. Consequently, schemes are much smaller - the average UK DC scheme holds assets of under €2m (£1.7m), compared to a European average of €455 million (£383m)[6]. | | |

[4] Fiduciary Duties of Investment Intermediaries, UK Law Commission 2014

[5] The evaluation of financial materiality is at the well-reasoned discretion of pension scheme trustees having taken appropriate advice.

[6] Source: Spence Johnson. Original figures provided in euro. http://www.pensions-expert.com/Comment-Analysis/Scheme-fragmentation-more-stark-in-private-sector-than-public?ct=true

There is evidence that scheme size is positively correlated with good governance and ESG practices[7]. We understand that consideration of ESG factors is as much about priorities and intention as it is about scale; several small schemes integrate ESG very well. Outsourcing to asset managers or through fiduciary management structures can also help overcome scale-related issues. However, where schemes are unable to retain internal expertise, this can result in over-dependence on consultant advice.

Size can convey a number of advantages. It can reduce management and advisory costs through giving asset owners a better negotiating position with service providers. Scale can also embed trustee expertise and enable engagement with investee companies through in-house fund resourcing and size of holding.

It seems unlikely that pension scheme consolidation will occur at scale in the absence of further regulatory encouragement. We also note that the government has identified improving governance as a near-term policy priority. Scheme consolidation has two key sources. Firstly, trustees reflecting on the adequacy of their governance arrangements and secondly, the government ensuring that consolidation methods are less complicated. This will enable schemes to consider consolidation a reasonable option available to them.

The PRI's recommendation is that schemes should have to reflect on whether scale has a negative impact on scheme governance and performance, including the consideration of ESG factors and costs. This should occur every three years, with the results being reported to both the scheme membership and TPR. The government should simplify the procedures for pension scheme consolidation.

## QUESTION 4: ETHICAL PENSION OPTIONS

(Call for evidence, paragraph 1.18)

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?

There has been significant recent growth in the number of workplace pension schemes offering ethical funds. As of 2014, 60% of workplace DC schemes offered an ethical option[8]. However, it is worth noting that the definition of "ethical" or "socially responsible" is not clear. For screened funds, the reduction in investment universe can vary significantly.

[7] http://www.thepensionsregulator.gov.uk/press/pn15-46.aspx

[8] Source: Towers Watson 2014 pension survey

We have found little evidence of their widespread uptake. As noted elsewhere, the vast majority of DC savers use the default fund.

Five-year financial results from 91 'ethical and sustainable' funds are available from Trustnet[9], though we note that this relies on the fund's own classification – they do not use a uniform definition of 'ethical and sustainable'.

## QUESTION 5: PENSION SAVER ENGAGEMENT

(Call for evidence, paragraph 1.18)

We seek views about how far these options (identified in Question 4) 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?

| **Yes:** | No: | Other: |
|---|---|---|

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

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

Public scrutiny of the investment industry has increased with concern regarding its impact on society and the environment more generally. We anticipate that beneficiaries, particularly millennials[10], will want to engage with their retirement providers on environmental and social issues[11]. This will add to the rising demand for ESG information and methods. We would expect this to occur whether or not Social Investment options were provided as fund options.

There is evidence that a majority of UK savers prefer their investments to minimise negative impacts. Research conducted by YouGov on behalf of the PRI in 2015 found that UK savers would prefer to avoid investing in companies involved in fossil fuel production (50%), child labour (79%), exploiting tax loopholes (67%) and excessive CEO pay (68%). However, we note several barriers to further engagement:

- Scheme members lack the information to evaluate whether the funds on offer comply with these preferences. The PRI/YouGov survey found that just 19% of scheme members know all of the companies in which their pension is invested. Around 60% would like more information from their fund manager - this could include more

[9] https://www.trustnet.com/ia-unit-trusts/price-performance?univ=O&fundFocus=I:ETHL

[10] Millennials, Women and the Future of Responsible Investing: https://riacanada.ca/millennials-women/

[11] How Millennials Could Upend Wall Street, https://www.brookings.edu/research/how-millennials-could-upend-wall-street-and-corporate-america/.

information on the companies they are invested in, a description of how they manage environmental and social risk, or greater consultation about their interests and needs.

- Some traditional exclusion-based SRI funds would not exclude companies involved in these activities as they screen out specific sectors (eg. tobacco, weapons manufacture) rather than controversial business practices.
- Lack of trust in the industry. The 2016 Edelman trust barometer continues to find that finance is the least trusted industry[12]. Almost a quarter of UK millennials do not trust financial service providers with their money[13]. Offering impactful investment will not alleviate the industry-level trust barrier. Furthermore, beneficiaries do not think the industry is responsive to their concerns. PRI's research suggests only 3% of savers feel their fund manager would be responsive if they raised concerns around the impact of their investments.

## QUESTION 6: RETURNS FOR SOCIAL INVESTMENT

(Call for evidence, paragraph 1.18)

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?

| Yes: | No: | **Other:** |
| --- | --- | --- |

As noted above, chosen funds have considerably more flexibility to pursue social impact objectives to the detriment of financial returns. Provided that appropriate advice is given to beneficiaries, we consider this a welcome innovation.

We also recommend reforms to the IGCs. As noted by the OFT, the buy side market for DC funds is extremely weak[14] and DC arrangements have historically been associated with less efficient investment profiles and higher costs.

We welcome the introduction of IGCs for contract-based DC schemes. Fiduciary duties and associated governance structures have developed for trust-based scheme to bring greater rigour and expertise to investment decision-making.

[12] http://www.edelman.com/insights/intellectual-property/2016-edelman-trust-barometer/state-of-trust/trust-in-financial-services-trust-rebound/

[13] https://www.bnymellon.com/_global-assets/pdf/our-thinking/business-insights/the-generation-game.pdf

[14] OFT study

| If Social Investment options are added as a feature of the chosen funds within contract-based schemes, it will be necessary for there to be a mechanism in place for monitoring their on-going suitability as a fund investment option.<br><br>In our recent UK roadmap for Fiduciary Duties, we propose that the remit of IGC's should be extended to include an assessment of long-term value creation, product suitability and engagement practices (in addition to the current value for money test, which is fee-focused). This is a consistent extension to recent policy making, which has sought to improve the oversight of DC investment practices in contract-based schemes. |
|---|

## QUESTION 7: FINANCIAL ADVISORS AND SUITABILITY

(Call for evidence, paragraph 1.22)

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?

| No PRI response |
|---|

QUESTION 8: LABELLING SOCIAL INVESTMENT OPTIONS

(Call for evidence, paragraph 1.23)

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?

<table>
<tr><td><u>Yes:</u></td><td>No:</td><td>Other:</td></tr>
<tr><td colspan="3">As noted in our response to question 5, beneficiaries hold ethical preferences but have limited information regarding their investments.<br><br>Social Investment is also part of a broader category of investment, namely Social, Responsible and Impact investing. An extremely broad range of investment products, across different asset classes and maturity profiles, exists in this investing universe.<br><br>DC funds that are presented as "ethical" or "green" apply negative screens to exclude from their investment universe particular disfavoured sectors, such as alcohol, tobacco, weapons and, in some cases, carbon intensive industries. These funds might be characterised as "ethical" but do not seek to achieve specific outcomes, therefore could not also be characterised impact investing, social or otherwise. However, the language used to characterised these different investment approaches is not settled or subject to an industry standard and there is often a conceptual blurring between categories.</td></tr>
</table>

| We note several industry initiatives have already begun the process of certifying 'responsible' funds. These industry standards have tended to focus on assessing the quality of investment processes to ensure they are in line with a stated responsible investment policy.<br><br>We emphasise that the quality of the advice received and the clarity of information provided to beneficiaries is crucial in determining outcomes in DC schemes where the beneficiary exercises an active choice. We do also third party accreditation of schemes as having a role in adding an additional layer of information to enable beneficiaries to assess minimum scheme quality, such as PLSA's quality mark scheme[15]. |
|---|

QUESTION 10: LAW OF SOCIAL ENTERPRISES

(Call for evidence, paragraph 1.25)

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?

| Yes: | No: | Other: |
|---|---|---|
| No PRI response. | | |

FURTHER COMMENTS:

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.

[15] http://www.pensionqualitymark.org.uk/

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**PENSION FUNDS AND SOCIAL INVESTMENT**

This optional response form is provided for consultees' convenience in responding to our call for evidence on pension funds and social investment.

The response form includes the text of the questions in the call for evidence, with boxes for yes / no answers (please delete as appropriate) and space for comments. You do not have to respond to every question. Comments are not limited in length (the box will expand, if necessary, as you type).

Each question gives a reference in brackets to the paragraph of the call for evidence at which the question is asked. Please consider the surrounding discussion before responding.

We invite responses from 7 November 2016 until **15 December 2016**.

Please return this form:

By email to: commercialandcommon@lawcommission.gsi.gov.uk.

By post to: Lucinda Cunningham, Commercial and Common Law Team,
Law Commission, 1st Floor Tower,
Post Point 1.53, 52 Queen Anne's
Gate, London SW1H 9AG

We are happy to accept responses in any form. However, we would prefer, if possible, to receive emails attaching this pre-prepared response form.

**Freedom of information statement**

Any information you give to us will be subject to the Freedom of Information Act 2000, which means that we must normally disclose it to those who ask for it.

If you wish your information to be confidential, please tell us why you regard the information as confidential. On a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not be regarded as binding on the Law Commission.

***The Law Commission processes personal data in accordance with the Data Protection Act 1998 and in most circumstances it will not be disclosed to third parties.***

## YOUR DETAILS



| | |
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## CONFIDENTIALITY

Do you wish to keep this response confidential?

| Yes: | No: x |
|---|---|
| If yes, please give reasons: | |

**QUESTION 1: BARRIERS TO PENSION FUND INVESTMENT**

(Call for evidence, paragraph 1.15)

What are the barriers to pension funds investing:

(a) In infrastructure generally?

(b) In socially significant infrastructure?

(c) In other forms of social investments?

In my research, undertaken to consider the choices that individuals make with pensions, how they make decisions and what influences action, a number of barriers to decision making were identified. The work of behavioural economics has identified a number of traits and behavioural biases that occur in a predictable way and policy and legislation has attempted to change the outcomes for individuals. However, this makes assumptions about a whole class of people and not everyone will demonstrate the same reaction and so a one size fits all approach results in the replacement of decision making with an alternative default position.

My research project was designed to consider the way that employees deal with Auto-enrolment, process information given on pensions and also what motivates or acts as a barrier to active decision making. It is clear from this research that any default position will be relied upon by employees and may be stronger where the information is given by a party which the employee places trust in, such as the employer. This is clear from evidence of movement from default investment funds and also in contribution levels, which often remain at the default level as the employee makes no active choice to change these. The introduction of auto-enrolment has increased both the volume of savings and the number of pension pots and so this question of investment and active choice is extremely important. My work found that introducing a trigger to change such as having a review discussion

or increasing employer matching amounts can lead to more engagement but employers were reluctant to become involved in this for fear of appearing to undertake an advisory role.

Barriers to decisions were described by employees in relation to many aspects of pensions from choosing investments to the level of contributions or whether to join at all. Time was used by individuals to justify procrastination. This arose in two ways. First, employees felt that they did not have enough time to read all the relevant information and make a decision and so they put off doing this until they had the time. Secondly, employees felt that the pension was something which related to old age and so they had plenty of time before needing to deal with the decisions such as investment. Others commented that it was not worth spending time on these decisions until a significant sum had been amassed in the pension pot.

Another major barrier to active decision making was uncertainty about past decisions. Poor understanding of the current position seemed to be off-putting and there was little incentive to change decisions where they had been forgotten or misunderstood.

The role of providers can also cause difficulty for employees when dealing with occupational defined contribution arrangements, often group personal pensions for the purposes of auto-enrolment. Employees were unsure whether they had access to financial or independent advice or information and sometimes placed trust in employers or providers to do the best for them in situations where there was a conflict between the best interests of the parties.

The major barrier to making decisions that was identified in my research was lack of engagement and understanding. Information given on pensions is often voluminous, dense and employees complained that they could not understand how it related to their own positions. As individuals were unsure where to get advice, decisions were often made on the basis with discussion with family or colleagues and often on the basis of choosing what the majority were doing. Information needs to be salient and streamlined if the aim is to promote active engagement and promote choice rather than simply use disclosure to demonstrate compliance with information provisions. However, salient information can be more expensive to provide and employers and product providers may be unwilling to undertake costs. The legal nature of the relationship is also important as the employee may seek to rely on the information as advice if it appears that the employer or provider has undertaken an advisory role. Consequently more generic information is provided to avoid any legal responsibility by the employer or product

provider. The use of technology can be helpful in some cases, with some employees engaging with intranet information and modelling software but others reported that they only had access to electronic information and had forgotten how to access it. However, it seemed that having a conversation with individuals about their choices helped to clarify matters and many reported that they would be looking into matters further with a view to taking action as a result of our conversations.

Where pensions are provided at the place of work, it must also be recognised that the employer is often viewed as a trusted party and so any default provided within the pension context will be heavily relied on.

It is crucial, whether trying to encourage choice in trust based DC schemes or through alternative funds offered through GPPs, that these issues are considered. The work of behavioural economics will assist in identifying some issues but not all individuals demonstrate the same reactions and so any policy changes need to reflect this to avoid negative or unforeseen consequences.

**QUESTION 2: LEGAL AND REGULATORY BARRIERS**

(Call for evidence, paragraph 1.15)

Do any of those barriers (identified in Question 1) relate to issues of law and regulation?

| Yes: x | No: | Other: |
|---|---|---|

The legal issues arising will depend on the legal structure of the pension being considered. For trust based schemes, the scheme trustee will have to consider the "best interests of the members" when considering investment and also the question of different sectors of membership as these will not always be aligned. The best interests is not necessarily the best financial interests for the fund but the trustees fiduciary and other duties may restrict the investment options as well as the specific statutory investment obligations

that trustees must comply with. For example, it might be in current member interests to invest in a way that will preserve the business and current jobs but this may not be in the best interests of pensioner members.

In relation to personal pension arrangements, and auto-enrolment pensions in particular, there are a number of specific legal requirements, including the charge cap which impact on reliance on default positions, including investments. The charge cap applies to the default fund only and so for many it will be seen as the best value for money and may even be perceived as advice to stay with that fund. In the context of workplace personal pensions, employees very rarely seek any professional advice and the role of the employer and product provider may not be clear. The contractual position often excludes any advisory role between provider and employer and between the provider and employees and so this results in the provision of more and more information as disclosure to the employee.

**QUESTION 3: SIZE OF PENSION FUNDS**

(Call for evidence, paragraph 1.15)

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

| Yes: | No: | Other: |
|---|---|---|
| | | |

**QUESTION 4: ETHICAL PENSION OPTIONS**

(Call for evidence, paragraph 1.18)

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: PENSION SAVER ENGAGEMENT**

(Call for evidence, paragraph 1.18)

We seek views about how far these options (identified in Question 4) 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?

| Yes: | No: | Other:x |
| --- | --- | --- |
| See response about in relation to research with pension savers. More choice does not mean more engagement (as is evident in research about the existing choices available to fund or contribution levels in pensions) unless people understand what the choices are, how to make choices and what the consequences of choices are. Without a different way of disclosing information and making advice available at limited cost, it seems that more choice by itself will not make a significant impact or | | |

| could lead to detrimental consequences for some. |
| --- |

## QUESTION 6: RETURNS FOR SOCIAL INVESTMENT

(Call for evidence, paragraph 1.18)

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?

| Yes: | No: | Other: |
| --- | --- | --- |
| | | |

## QUESTION 7: FINANCIAL ADVISORS AND SUITABILITY

(Call for evidence, paragraph 1.22)

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?

|  |
| --- |
|  |

**QUESTION 8: LABELLING SOCIAL INVESTMENT OPTIONS**

(Call for evidence, paragraph 1.23)

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?

| Yes: | No: | Other: |
| --- | --- | --- |
|  |  |  |

**QUESTION 10: LAW OF SOCIAL ENTERPRISES**

(Call for evidence, paragraph 1.25)

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?

| Yes: | No: | Other: |
| --- | --- | --- |
|  |  |  |

**FURTHER COMMENTS:**

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.

Pensions policy and legislation does not always exist comfortably within the existing private law framework and financial regulation environment and so any changes need to be considered within a wide context. One policy may impact on many other areas as we have seen with the increased volume of DC arrangements as a consequence of auto-enrolment. The introduction of improved governance structures and charge caps is one example. The increasing volume of group personal pension arrangements to comply with auto-enrolment has not been accompanied by increased volumes of seeking advice and, the introduction of upfront fees for financial advice at the point of the introduction of auto-enrolment may act as a barrier to employees and employers seeking advice which may lead to further disengagement and over-reliance on defaults.

Law Commission
Reforming the law

**THE LAW COMMISSION**

**PENSION FUNDS AND SOCIAL INVESTMENT**

This optional response form is provided for consultees' convenience in responding to our call for evidence on pension funds and social investment.

The response form includes the text of the questions in the call for evidence, with boxes for yes / no answers (please delete as appropriate) and space for comments. You do not have to respond to every question. Comments are not limited in length (the box will expand, if necessary, as you type).

Each question gives a reference in brackets to the paragraph of the call for evidence at which the question is asked. Please consider the surrounding discussion before responding.

We invite responses from 7 November 2016 until **15 December 2016**.

Please return this form:

By email to: commercialandcommon@lawcommission.gsi.gov.uk.

By post to: Lucinda Cunningham, Commercial and Common Law Team,
Law Commission, 1st Floor Tower,
Post Point 1.53, 52 Queen Anne's
Gate, London SW1H 9AG

We are happy to accept responses in any form. However, we would prefer, if possible, to receive emails attaching this pre-prepared response form.

**Freedom of information statement**

Any information you give to us will be subject to the Freedom of Information Act 2000, which means that we must normally disclose it to those who ask for it.

If you wish your information to be confidential, please tell us why you regard the information as confidential. On a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not be regarded as binding on the Law Commission.

***The Law Commission processes personal data in accordance with the Data Protection Act 1998 and in most circumstances it will not be disclosed to third parties.***

**YOUR DETAILS**

| | |
|---|---|
| Name: | [redacted] |
| Organisation: | USS Investment Management |
| Role: | [redacted] |
| Postal address: | [redacted] |
| Telephone: | [redacted] |
| Email: | [redacted] |

**CONFIDENTIALITY**

Do you wish to keep this response confidential?

| | |
|---|---|
| | No: |
| If yes, please give reasons: | |

**QUESTION 1: BARRIERS TO PENSION FUND INVESTMENT**

(Call for evidence, paragraph 1.15)

What are the barriers to pension funds investing:

(a) In infrastructure generally?

(b) In socially significant infrastructure?

(c) In other forms of social investments?

A: For the ethical options associated with its DC offerings (which include an ethical lifestyle fund), USS attempted to identify funds which could provide and environmental, social or ethical upside for our members. We found none available that were within the cost bounds of our funds and suspect that it would be difficult to find this at the charge cap of 0.75%. Most funds of this nature are wrapped in a private equity like fee structure, and thus become very expensive.

Direct investment in infrastructure requires resource levels that the majority of pension funds do not have access to.

For DC, the need for daily pricing and high levels of liquidity may also be making it more difficult for pension funds to invest in infrastructure.

B: USS as a scheme believes it owes the same fiduciary duty to members in its DC section as in its DB section– that is best financial interests/financial factors first and foremost. The default funds therefore have to provide appropriate financial returns first and foremost, and social and environmental issues follow from this. In its DB

| fund, USS does invest in a range of renewable and low carbon assets.<br><br>C: whether real or not, there is a perception that investing for social returns requires pension funds to give up financial returns for their members. As such, and following the fiduciary guidance available to most pension funds, allocations to this area are less likely. |
|---|

**QUESTION 2: LEGAL AND REGULATORY BARRIERS**

(Call for evidence, paragraph 1.15)

Do any of those barriers (identified in Question 1) relate to issues of law and regulation?

| Yes: | No: | Other: |
|---|---|---|
| Daily dealing and pricing of funds is difficult when they include illiquid assets. | | |

**QUESTION 3: SIZE OF PENSION FUNDS**

(Call for evidence, paragraph 1.15)

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

| Yes: | | |
|---|---|---|
| Large pension funds get greater access to funds and are frequently able to negotiate better fee structures (as their allocations to particular funds will be greater). That said, on the negative side larger funds are more likely to hit capacity constraints in products and asset classes<br><br>On balance, however, we believe larger schemes are in a stronger position and hence this reinforces the need for there to be significant consolidation across pension funds in the UK. This applies not only to local government schemes (where quasi consolidation is occurring) but also to the other thousands of small and subscale schemes in the country. Following the example of pension regulators in Australia would be a good idea. | | |

**QUESTION 4: ETHICAL PENSION OPTIONS**

(Call for evidence, paragraph 1.18)

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?

| (a) In the DC section of USS, members have access to two types of ethical investment fund. They can choose an ethical lifestyle fund, which is the first of its kind in the UK and incorporates ethical equities, bonds, and cash, or they can choose to invest in a stand alone ethical equity fund. These investments are negatively screened according to ethical guidelines influenced by the preferences |
|---|

| members expressed in a large scale survey completed by 10,000 active members.<br><br>(b) USS's DC options have only been live for 2 months. 27% of around 11,000 members making active investment choices are invested in the ethical lifestyle fund, and 8% have chosen the ethical equity fund. However, this constitutes circa 1% of our members take up these funds.<br><br>c) Track records are only available for 2 months and therefore not likely to be statistically significant. |
|---|

**QUESTION 5: PENSION SAVER ENGAGEMENT**

(Call for evidence, paragraph 1.18)

We seek views about how far these options (identified in Question 4) 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?

| Yes: | No: | Other: |
|---|---|---|
| A: As this consultation already notes, the vast majority of pension savers simply save into the default option. Provision of additional choice may simply add to the levels of confusion felt by many when faced with decisions they do not feel competent to make.<br><br>b) As noted above, USS looked for this type of option for its default and self-select ethical options but were unable to find any that were appropriate for the scheme. If they were available, and at appropriate costs, they may be more widely adopted by pension funds. | | |

**QUESTION 6: RETURNS FOR SOCIAL INVESTMENT**

(Call for evidence, paragraph 1.18)

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?

| Yes: | No: | Other: |
|---|---|---|
| A: as noted, where these funds are available they are usually too costly for inclusion in pension funds. There are arguably also not enough underlying assets which are easily daily priced and traded to make allocations in these areas, which also needs to be considered<br><br>B: When making long term investment decisions for a pension, where the compounding nature of returns is critical, a focus on the financial returns is essential. Contributors to DC options should be provided appropriate information so that they | | |

| can take informed decisions as to the likely implications of choices they are making i.e. the increase in risk posed by less diversification. |
|---|

**QUESTION 7: FINANCIAL ADVISORS AND SUITABILITY**

(Call for evidence, paragraph 1.22)

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?

| No Comment |
|---|

**QUESTION 8: LABELLING SOCIAL INVESTMENT OPTIONS**

(Call for evidence, paragraph 1.23)

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?

| | | Other: |
|---|---|---|
| This might be helpful in aiding member choice. However, if adopted it should be done so in a way that does not add additional costs to either members or schemes as these eat away at pension returns. | | |

**QUESTION 10: LAW OF SOCIAL ENTERPRISES**

(Call for evidence, paragraph 1.25)

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?

| | | Other: |
|---|---|---|
| USS has no view on this. However, if adopted, appropriate investor protections should be in place to ensure that pension monies were not put at additional risk, and investments should be subject to the same level of scrutiny and legal protections as other asset classes. | | |

**FURTHER COMMENTS:**

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.

| |
|---|

**Vigeo Eiris' Response to the Law Commission consultation**
**'Pension Funds and Social Investment: Call for Evidence'**

**Introduction to the Respondent**

Vigeo Eiris is a global provider of environmental, social, and governance (ESG) research to investors and corporates. Formed from the merger of Vigeo and EIRIS in December 2015, Vigeo Eiris provides research and solutions for sustainable value creation. Vigeo Eiris offers two types of services through separate business units. Vigeo Eiris Rating, utilising its teams' expertise and its unique and well-regarded methodologies, offers a large range of products and services designed for investors and asset managers engaged in sustainable and responsible investment practices. This research covers more than 4,000 ESG issuers and up to 10,000 for controversial weapons. Vigeo Eiris Enterprise works with organisations of all sizes, from all sectors, public and private, to support them in their CSR measures. Please visit www.eiris.org and www.vigeo.com for more information.

EIRIS (now part of Vigeo Eiris) previously responded to the 2014 Law Commission consultation on Fiduciary Duties of Investment Intermediaries and the response is available here: http://www.eiris.org/wp-content/uploads/2013/04/Response-to-the-Law-Commission-Review-of-Institutional-Investors-Fiduciary-Duties.pdf

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**Contact Email:** stephen.hine@eiris.org

- **Introductory & General Comments in Response to the Consultation**

A. Vigeo Eiris welcomes the Law Commission's Consultation. We are grateful for the opportunity to comment. We are keen to see a greater take up of social investment because of the impact it can make, and we support the Law Commission's view that this is a positive step for pension funds.

B. Vigeo Eiris provides research to many of the entities the Government is concerned about in the context of the Consultation. Vigeo Eiris empowers charities, social enterprises and pension funds with Vigeo Eiris Rating research on environmental, social and governance risks, to inform their investment decisions. Vigeo Eiris Enterprise empowers businesses to develop their Corporate Social Responsibility strategies and to integrate environmental, social and governance factors therein. Given our interaction with these stakeholders, we have a keen interest in this consultation.

C. Vigeo Eiris is also well placed to provide comment given the knowledge we have of both the UK and French markets as Vigeo Eiris is the new entity recently formed from the merger of EIRIS (based in the UK) and Vigeo (headquartered in France).

D. The consultation asks questions about labelling social investment funds. Whilst we provide an answer to Question 9 later in this response, we would like to raise the complexity of the issue of labelling as an overarching issue. Labels can be a useful tool for individuals and institutional investors who need visible, accessible and reasonable assurance of convergence between their beliefs and/or their expectations and the investment products and vehicles in the market. What's crucial is to ensure clear and exhaustive information on a label's aim, its governance, the scope, the methods, frameworks and metrics. However, Vigeo Eiris London is aware of investor concern from the UK market that labelling can potentially stifle innovation in ESG development (which is a broad and varied area) through

standardisation. What may be a good label for one investment may not be so good for others. Labelling therefore needs to be carefully explored as the labelling process may inadvertently restrict the development of ESG investments in some ways that might otherwise be freer to develop without the labelling. For companies we have experience of labelling certification: Vigeo Eiris Enterprise can provide companies with a global audit in line with the ISO 26,000 standard, as well as certification with Label Lucie and Label CGEM. Please see question 9 for our further comments on labelling.

E. We would like to explore the stated focus of the Consultation on 'social investment' and the stated definition. We are concerned that the narrower focus on 'social investment' does not take into account the potential breadth of strategies, issues and risks that pension funds can address through 'responsible investment'.

   a. The Consultation refers to 'social investment' and defines this as 'an investment which combines financial and social objectives'. The Consultation then cites the Financial Conduct Authority: *'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…. Social investment is different from charitable giving or making a donation as there is an exception that capital may be returned and some financial gain could be made.'*

   b. We would like to draw attention to the differences between 'social impact' and 'social responsibility' (i.e. doing no harm), which is different from the definition given in the Consultation. The Consultation appears to be focusing on positive investment strategies, but other responsible investment strategies can have constructive impact too through the consideration of ESG factors and it is important that the landscape for development of ESG and responsible investment is not stifled by narrower focus on positive screening.

   c. At Vigeo Eiris we tend to use 'responsible investment' as an umbrella term that captures a broad range of investment strategies (positive screening, negative screening, integration, engagement, thematic etc.) that consider environmental, social and governance factors in investment decision-making. To a large extent various terms can be used interchangeably and the term 'responsible investment' can encompass them all. Charities and trustees often still feel comfortable with the term 'ethical investment', which can also refer to other terms, such as 'socially responsible investment' and 'responsible investment'.

   d. 'Responsible investment' can have a social impact too, as well as "social investment", as strictly defined by the Consultation. Charities, for example, may choose to pursue responsible investment for different reasons, whether to manage ESG risks in the long-term, to align charitable mission with investment, or to avoid risks to reputation from alienation of supporters. As the Charitysri resource states *"Responsible Investment is about aligning a charity's investments with its mission. It is based on achieving the greatest impact from investments by both pursuing financial return and using investments for non-financial gain. It is about using investments to complement rather than counter a charity's aims."*[1] We are keen that the breadth of ways that pension funds can potentially make a difference through responsible investment is not stifled by the focus of this consultation on positive social investment.

   e. We would also like to highlight the question of where thematic funds may fit on the spectrum of 'social investing' given the Consultation's definition of 'social investment' as 'an investment which combines financial and social objectives'. Thematic funds are funds that may focus on investing in a specific theme e.g. water, renewable energy, or investment in positive sustainable goods and services, for example.

F. Paragraph 1.7 of the Consultation suggests that the Law Commission has moved from a focus on negative screening in its fiduciary duties report, to a focus here on investing in social good. Care needs to be taken that the middle ground between these two suggested strategies is not ignored: namely, the investment benefits of ESG decision-making. Furthermore, we would also draw attention to the

[1] http://www.charitysri.org/homearea/faq.html#question1 Charitysri is an EIRIS Foundation project

significant development of the EU Directive on Institutions for Occupational Retirement Provision ('IORP2') which should be taken into account in this context. Assuming this is implemented in the UK, all pension funds will need to be thinking about how they pursue ESG in investment.[2]

G. In paragraph 1.8 of the Consultation comment is included to the effect that "the social element [of pension investment] may also provide "counter-cyclical stability": in other words, in periods of recession, when traditional investments do badly, social investments may do well." This comment is not substantiated in the Consultation. We would like to raise the question of theory on counter cyclical stability. Why are social investments counter cyclical? It could be argued that social investments may also do well in periods of growth, not just in periods of recession. In our view this is an interesting notion which merits genuine investigation, especially as it would prove particularly germaine to the subject matter in hand.

- **Question 1: What are the barriers to pension funds investing in a) in infrastructure generally? b) in socially significant infrastructure? c) in other forms of social investments?**

  We can offer no evidence to support this question. However, from our awareness of the pension market we would like to comment that liquidity appears to be a problem for pension funds investing in infrastructure, particularly for small pension funds. Access to investment via an asset manager can also be an issue.

  In response to 'C)' the perception that there is something different for 'other forms of social investments' can be a barrier to pension funds investing in other forms. It would be helpful if 'other' options were clearer and considered as part of a continuation in the investment mix.

- **Question 2: Do any of those barriers relate to issues of law and regulation?**

  Not answered.

- **Question 3: Is the size of funds a major issue? If so, are there legal obstacles to scheme mergers?**

  Anecdotally we are aware that the size of funds is an issue, for the reasons as set out in the Consultation. In our view there are not any particular legal obstacles to scheme mergers. From examples of pension funds merging, there may be some obstacles to overcome in terms of meeting liabilities etc., but it is clearly possible to have scheme mergers.

  We would also like to highlight the example of the Local Government Pension Scheme pooling – whilst this is not a scheme merger, it also shows there can be pooling of investment activity without the merging of funds. The challenge here is just collaboration on investments.

  We also raise here that it is our understanding that MFID II has had the unintended consequence of making Local Government Pension funds retail, and it is plausible that it has had the same effect on other funds. This may be an obstacle: namely, coming together as something not authorised, and so having a significant detrimental effect on the services they can procure.

- **Question 4: We wish to hear from employers and pension providers about ethical options currently on offer (whether positively or negatively screen). A) What ethical DC pension funds are available? B) What proportion of people take them up? c) What sort of returns do they provide?**

  A. Vigeo Eiris London employees are offered a choice of pension fund options. Among these is an Ethical Fund offered by the Pensions Trust which we understand has outperformed versus benchmark since inception.

[2] See Proposal for a Directive of the European Parliament and of the Council on the activities and supervision of institutions for occupational retirement provision http://data.consilium.europa.eu/doc/document/ST-10557-2016-ADD-1/en/pdf

- **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?**

  Awareness and concern about ethical issues by consumers is increasing. EIRIS' October 2013 IPSOS MORI national consumer survey explored attitudes to ethical or green pension options in Great Britain. The poll surveyed 2015 adults. The poll explored the extent to which people are concerned about whether the companies in which their pension fund invests abide by certain global conventions and principles. The results reveal a desire that pension funds and their investment managers inform individual adults about the extent of their compliance with global conventions and principles. A significant number of adults would be motivated by green or ethical concerns to switch pension funds.

  Key findings:

  - 65% of adults felt that it was either essential or very important that a pension scheme invests in companies that act in line with conventions and principles that prevent child labour; 65% felt the same on preventing forced labour; 55% on respecting workers' rights; 54% on protecting human rights, and 46% on safeguarding the environment.

  - 10% of adults would like to be informed of how far a pension fund complies with global conventions and principles when selecting a fund for the first time; 43% would like to be informed annually of how their funds implement these in their investments; 18% would like to be informed every six months and 18% would like to be informed quarterly.

  - The poll found that nearly a fifth (18%) of adults would like to see 100% of their pension scheme invested in a fund that avoids anything where there may be a negative environmental, social or governance (ESG) impact. 15% of people would like to see up to a quarter % of their pension scheme invested in a fund that avoids anything where there may be such an impact.

  - Close to one in five (19%) of respondents would either be very or fairly interested in switching the standard default pension offered by their employer to a green and ethical product even if its financial performance rates and benefits were slightly less than other similar pension funds without an ethical or green focus. 45% would be either very or fairly interested in switching if the financial performance rates and benefits of the ethical or green fund were as good as other pension funds without such a focus.[3]

  We consulted staff on whether a greater range of options would encourage greater pension saving. We received limited response, but the feedback received highlighted that to get better engagement better information is crucial: namely, easier to understand information about how schemes work and also the administration.

  B. Again, we consulted staff on whether options seeking social impact as well as financial returns would encourage engagement. The limited feedback we received was yes they would, but raised the question of whether separate types of funds (possibly more risky in themselves) or one part of a fund. The comment highlighted that such preferences are never easy to separate out clearly. Also feedback suggested that divestment should not necessarily be treated as a lesser option to social impact. For example, the fairly widespread adoption of fossil fuel divestment, which is of interest to a broad spectrum of the investment public.

- **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**

[3] EIRIS press release http://www.eiris.org/media/press-release/dc-pension-holders-seek-ethical-option-as-uk-ethical-investment-grows-to-12-2-bn/ (October 2013)

**both social impact and market returns? b) How far should savers be prevented or discouraged from sacrificing returns for social impact?**

A. In our view there are currently a wealth of investment opportunities to potentially do this, if we define social investment as 'social responsibility' and 'ESG', taking into consideration the breadth of strategies and risks / issues that these encompass. Please see the Introduction to our response for a discussion of these concepts.

B. In the context of our definition of social responsibility, ESG and responsible investment, savers need to be made aware of the risks and opportunities that they are choosing and therefore it would be misrepresenting to only talk about *sacrificing returns* for social impact, where there are demonstrable positive returns to be made from investing in a socially responsible way.

   In our view, ESG issues (such as climate change, water, biodiversity, bribery and human rights etc.) can be financially material for some companies, either now or in the future. On the financially material point, it is worth citing as an example academic research using EIRIS' data that supports similar findings: a strong correlation has been found between corporates highly rated by EIRIS on environmental criteria and a reduction in worst-case-scenario risk.[4] Recent research by Barclays is a further example of market research that shows the possible correlation between good ESG performance and investment return on fixed income.[5]

- **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. The Consultation refers in paragraph 1.21 to the FCA receiving 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, and advisers felt hampered by a lack of definitive framework for measuring social impact. In our view, it is incumbent upon product providers (i.e. asset managers etc.) to explain to IFAs the products and the measures in place to measure them, so that IFAs feel able to consider and offer these options to clients.

B. Certification schemes could be considered as possible frameworks for measuring social impact. For example, Vigeo Eiris offers a Green Bond third party opinion service, which provides an opinion on the green bond issuer's credibility in terms of social responsibility policies and practices. This approach could be used for other areas for measuring impact. Another area of research that is relevant here is Vigeo Eiris Rating's Sustainable Goods & Services research service, which evaluates a portfolio and assesses what percentage of a company's activities are contributing to sustainable development (for each company in a portfolio) and then classifies the impacts of each company according to 9 themes in line with The United Nations' Sustainable Development Goals.[6]

   Furthermore, we would also suggest that financial advisers need to understand and communicate the concept of 'materiality', to enable their clients to understand the investment return aspect. Also financial advisers need to communicate the long-term nature of ESG and responsible investment to investors. It is very important that financial advisers can effectively communicate this to their clients as financial advisers don't have as much leverage as other institutional, larger funds.

- **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?**

[4] Using data from EIRIS from an annually updated FTSE All World Developed universe of companies from January 2005 to October 2010 (24 countries, c.1,800 firms per annum) and their ratings by EIRIS on five different environment criteria (Environmental Policy, Environmental Management, Environmental Impact, Environmental Reporting and Overall Environment), Dr Andreas Hoepner and Michael Rezec from the Centre for Responsible Banking and Finance, previously at St. Andrew's University, and Dr Sebastien Siegl from Scandinavia's Sustainable Investment Research Platform (SIRP), find what they describe as 'reduced realised risk' for those companies EIRIS scored as 'exceptional' on environmental criteria.

[5] https://www.investmentbank.barclays.com/our-insights/esg-sustainable-investing-and-bond-returns.html?icid=esg_103116_hero1.html

[6] Please visit www.vigeo.com for more information

On Monday 26 September, Michel Sapin (French Minister of Economy and Finance) entrusted to Nicole Notat (President of Vigeo Eiris) the presidency of the SRI Label Committee in France. Launched in September 2015 the French SRI Label, supported by public authorities, aims to foster the visibility of socially responsible investment management by investors.

Labels can be a useful tool for individuals and institutional investors who need visible, accessible and reasonable assurance of convergence between their beliefs and/or their expectations and the investment products and vehicles in the market. What's crucial is to ensure clear and exhaustive information on a label's aim, its governance, the scope, the methods, frameworks and metrics.

However, there is a possible downside of labels which some investors in the UK have voiced concern over to us. Potentially standardised labels can supress innovation in ESG developments – whether by issue or strategy. Ideally, labels should not pigeon-hole investments, but celebrate innovation whilst also providing a mark of assessment that investors can trust.

- **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?**

We would raise for consideration whether Brexit may mean that UK social enterprises will lose access to certain EU funding. This may in turn mean that further thought is needed about how the role of public policy directing funding towards social enterprises is going to change. The legal framework may need to be reviewed to reflect the fact that the funding landscape for many social enterprises may change significantly.

**December 2016**

worthstone
inspiring impact investment

# Law Commission Pension Funds and Social Investment: Call for Evidence

## Worthstone Consultation Response

**15th December 2016**

# Executive Summary

The UK financial services market leads the way in the area of social investment (SI) and Worthstone welcomes the Law Commission taking a lead and examining where they can bring about valuable changes.

Worthstone exists to help bring SI to maturity amongst the wealth adviser community. Within this review we look to collate information we have gained from:

- our knowledge of the market
- survey relating to the Social Investment Academy event on March 2016.

Our research shows:

- a significant proportion of advisers surveyed are talking to clients about SI, albeit this appears to be with a limited number of their clients
- combined with evidence of growing consumer demand for SI this may result in an 'advice gap' in this area
- a continuing theme from advisers is the concern over PI insurance and the Financial Ombudsman Service (FOS) related to SI advice.

From our research and experience, we believe the following key areas need to be addressed:

### The need for accredited education, training and competence assessment

We believe accredited education, training and assessment is one of the key strategies for bringing SI to the mainstream of the RIA market because consumers, PI insurers and regulators can take comfort in knowing advice is being offered by people who have invested in themselves by acquiring qualifications within such a specialist environment. We therefore recommend that the Law Commission should support the initiative of an accredited training module on SI.

# Introduction

**Introduction to Worthstone**

Worthstone exists to help bring social investment (SI) to maturity amongst the wealth adviser community. We are focused on delivering a service exclusively in the area of SI and exclusively to regulated investment advisers (RIAs) including financial advisers, financial planners and wealth managers. We are a social purpose business ourselves.

**Worthstone Knowledge Base**

## Market Knowledge

We have been delivering services to RIAs as well as carrying out qualitative and quantitative research on the triggers and barriers in this market with in excess of 500 unique RIAs and professional services individuals (lawyers and accountants) over the last 5 years. We have published research commissioned by Big Society Capital, the City of London and Nesta on this market as well as helping Cabinet Office and HM Treasury with our specialist expertise. We have also established the Social Investment Academy, the leading forum for retail social investment advisers, product providers and key market participants.

## Social Investment Academy (SIA) 2016 survey

Live Audience Survey

- Delegates were posed four questions, each with multiple choice answers and were asked to vote on which answer best met their response
    - We will report on three of those questions to provide a level of context
- The number of responses for each question varied slightly as delegates took different amounts of time when answering; this averaged out to approximately 70 delegate responses per question[1].

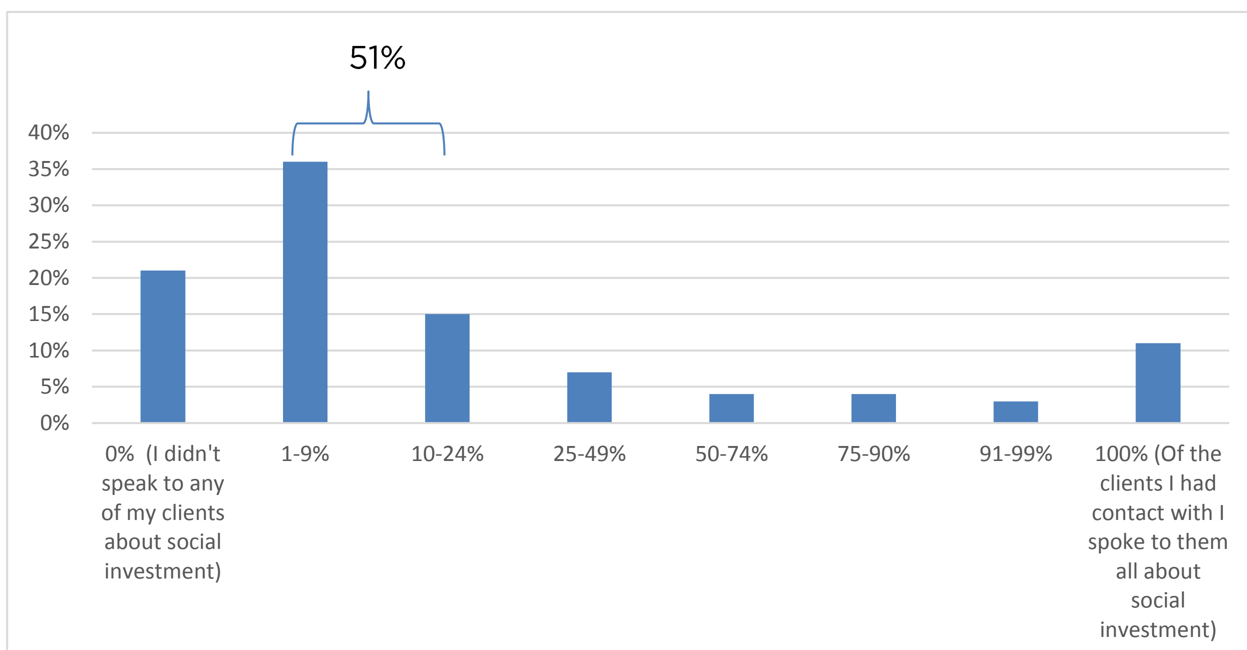
[1] Although this is a relatively small sample from a research perspective, it is a sample of the financial advisors who are likely to be most interested in this area by virtue of the fact that they have committed resource (time and cost) to attend the Social Investment Academy.

# Consumer demand for social investment

Data on adviser engagement with their clients and current investor interest in social investment was gained from responses to the following questions:

*Question: Thinking about the calendar year 2015, with what percentage of your clients that you had contact with, did you discuss social investment?*

**Figure 1.** Live audience survey, SIA '16 (approx. 70 Financial adviser/wealth manager responses)



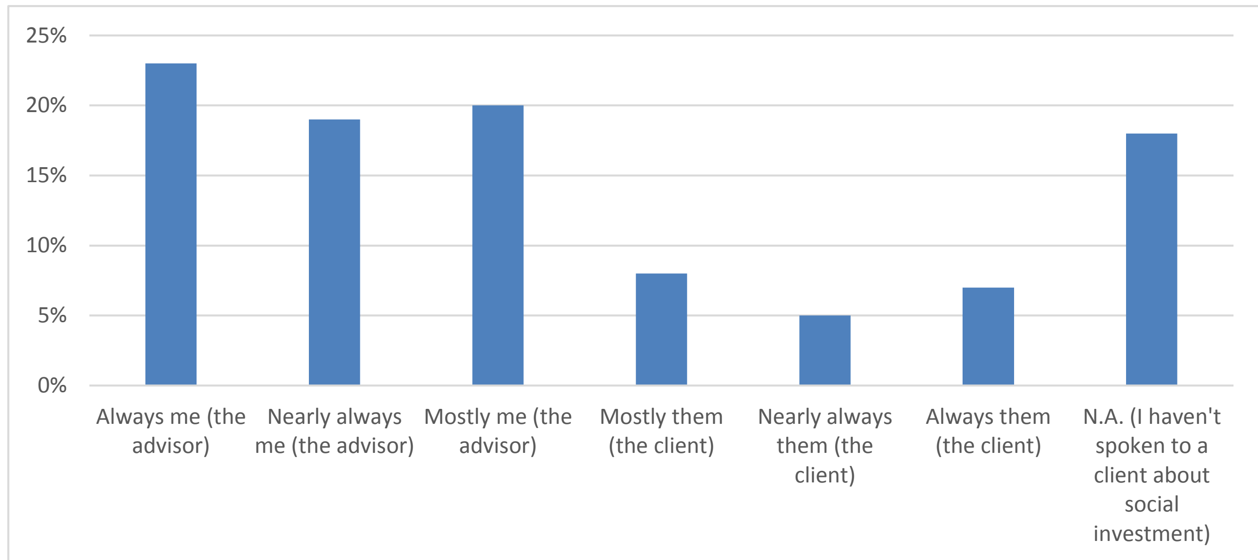

- nearly 80% of respondents are discussing SI with clients they had contact with last year, which is encouraging
- just over a tenth (11%) of advisers discussed SI with 100% of their clients with whom they had contact
- in excess of a third of respondents (36%) indicated that last year they had discussed SI with only 1-9% of their clients with whom they had contact
    - This increases to over half (51%) when looking at 1-24%.

Therefore, although there are many advisers discussing SI, they are only talking to a small number of their clients. This might be expected considering that these investments have previously often been held in wrappers which can be deemed suitable for a small minority of clients.

*Question. Thinking about who raised the topic of social investment in those discussions with clients, would you say it was:*

- *a) Always me (the adviser)*
- *b) Nearly always me (the adviser)*
- *c) Mostly me (the adviser)*
- *d) Mostly them (the client)*
- *e) Nearly always them (the client)*
- *f) Always them (the client)*

**Figure 2.** Live audience survey, SIA '16 (approx. 70 Financial adviser/wealth manager responses)[2]



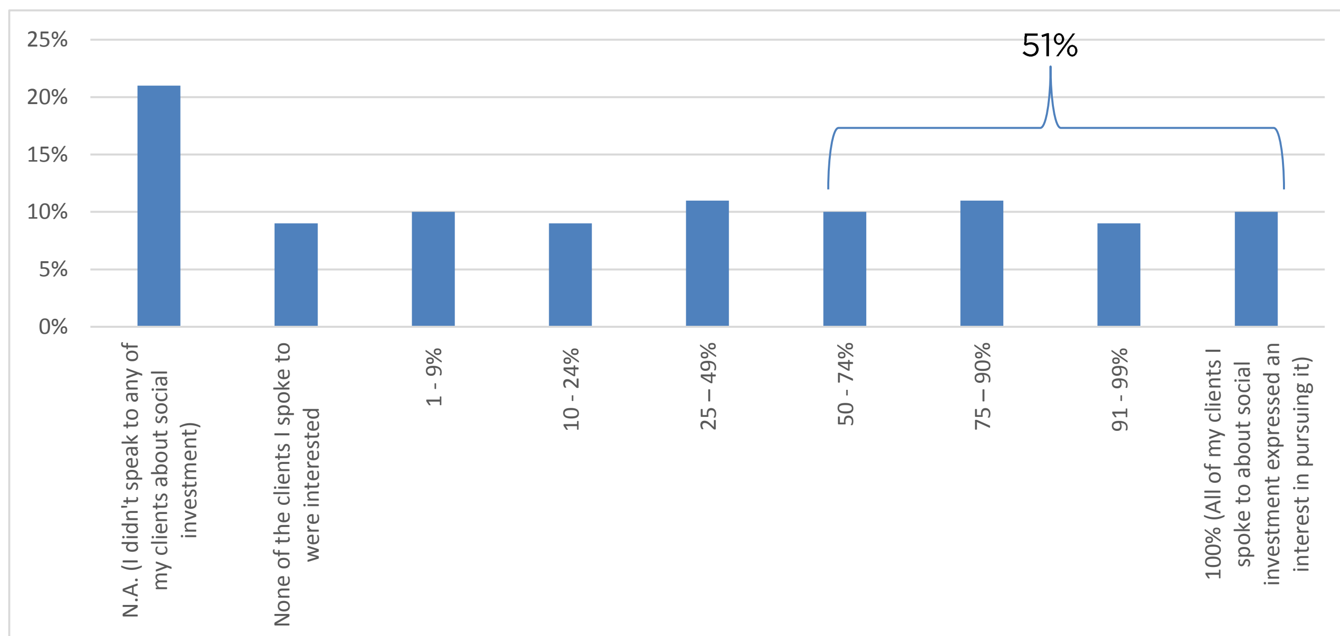

- the largest percentages, (23%, 19% and 20%, respectively), were seen for "Always me (the adviser)", "Nearly always me (the adviser)" and "Mostly me (the adviser)".

As a greater likelihood of raising the topic appears to be with the adviser, this poses the question: are clients not instigating this conversation because of a lack of awareness or because of their belief that their adviser wouldn't ordinarily advise in this area?

[2] NB. Just under a fifth (18%) of respondents in this question answered that they have yet to speak to a client about SI, thereby corroborating the 21% who answered to this effect in the previous question.

*Question. Of those you spoke to, what percentage expressed an interest in pursuing the area of social investment?*

**Figure 3.** Live audience survey, SIA '16 (approx. 70 Financial adviser/wealth manager responses)[3]




- respondent percentages were roughly equal across all answers
- when looking at only those who did speak to their clients, it is reassuring to see that over half (51%) found that 50% or more of their clients expressed an interest in pursuing the area of SI.

**Conclusion**

The key point here is that 89% of respondents who spoke to their clients last year say there is an interest from the clients in pursuing the area of SI. However, the number of advisers having those discussions is low, which indicates a potential advice gap for investors with objectives in this area who are not introduced to the opportunity to deploy wealth in this way.

[3] Roughly a fifth of respondents (21%) replied that they had not yet spoken to a client on this topic again corroborating these statistics from the previous questions.

**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?**

Each individual adviser process and client is different. Social investment will interest those advisers who service their clients from a goals-based perspective. Knowing their clients well and understanding their motivations is at the heart of their process; so, they will realise that an innovative solution such as SI will appeal to certain clients.

The primary objective of the financial adviser is to help the client meet his/her financial goals within their stated risk tolerance; it is important that the client has become comfortable with how these goals will be met before considering social investment. Consequently, the current regulations and processes that a qualified financial adviser must follow all remain extant.

Such advisers will also wish to understand the product and all its implications – from risk, compliance and technical (including taxation) perspectives. Thereafter, the financial adviser should clearly explain how social investment differs from conventional investment and how some of the conventional financial advice processes (including how performance is measured and reported) need to be adapted to take account of its unique nature. Throughout, it is essential to remember that advice suitability is what drives the advice process; the cornerstone of this is having a detailed understanding of the client's real objectives, their available resources, plus their attitude to investment risk and capacity for loss.

The strong culture of professional development within this stream of advisers will prompt a desire to learn by undergoing training, and demonstrate proof of learning through exam accreditation. This process gives the adviser the competence and confidence to address a new area of work with their clients, whilst affording compliance departments and PI insurers reassurance that the perceived risk which is intrinsic to innovation is being appropriately and responsibly managed.

It is our belief that the development of training materials about SI for the wealth adviser will allow them to do just this; to become competent and confident in this newly emerging area of SI by understanding the landscape. Similarly, the introduction of a relevant qualification will also have multiple benefits in that they will both promote and protect the sector, as the level of attention begins to grow.

## Conclusion

1. There is evidence of interest from investors in pursuing the area of SI, however, the number of advisers having those discussions is low which indicates a potential advice gap.

2. The development of the Social Investment Academy's adviser competency training for SI for the wealth adviser and the introduction of a relevant qualification will have multiple benefits.

Pinsent Masons

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15 December 2016

Dear Lucinda

**THE LAW COMMISSION**
**PENSION FUNDS AND SOCIAL INVESTMENT**

Please see below our response to the call for evidence.

The pensions team at Pinsent Masons LLP is one of the largest in the UK and includes a specialist pensions investment team led by Raj Sharma and Jae Fassam. We advise trustee, employer and local government clients on all aspects of pensions law in relation to funds of all sizes from £20m to £10bn+.

We have not responded, or not responded in detail, to certain questions where we do not feel that we have the necessary expertise or data to comment (in particular on questions 4, 5 and 6 relating to employer considerations and specific queries on availability of funds).

**QUESTION 1: BARRIERS TO PENSION FUND INVESTMENT**

(Call for evidence, paragraph 1.15)

**What are the barriers to pension funds investing:**

(a) In infrastructure generally?

(b) In socially significant infrastructure?

(c) In other forms of social investments?

We note that the call for evidence is focussed on DC provision. Our experience is related mainly to DB and DC funds held under trust (i.e. occupational pension schemes) where the Trustees take investment decisions (based on professional advice) on behalf of members.

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In all cases, the Trustees' duty is to act in the best interests of scheme beneficiaries and the current case law interprets that as meaning the best "financial" interests (*Cowan v Scargill* [1985] Ch. 270).

We recognise that some very large funds may have made investments for which social issues must be considered (a common example cited is a fund that has an investment in an asset (e.g. a port) which would lose value should global warming create a rise in sea levels that impacted that asset.

However, for the majority of our trustee clients, their investments are in a series of pooled funds or straightforward equity and bond portfolios (perhaps with some swaps or other hedging overlaying that portfolio) such that it is challenging to draw a direct link between social investment and the best financial interests of beneficiaries.

As discussed further below in our response to question 2, there is no part of the legislative framework that permits and/or excuses Trustees from the consequences of investing other than in the best financial interests of beneficiaries and this creates a "herd" mentality with very few small- or medium-funds willing to invest in a way that is out of step with the market.

In specific response to the assets classes you mention other barriers for the types of scheme we advise include:

(a) Infrastructure:

Viability of making direct investments – investing directly into infrastructure assets is a significant step up for any institutional investor, but especially for Trustees who are, essentially, volunteers. Even with the increasing number of professional trustees entering in the market, none have the time, experience or budgets to source infrastructure investment opportunities, conduct the necessary diligence let alone project manage and monitor them. Putting in place a direct investment programme would require a substantial, sophisticated in-house resource with the ability to make decisions quickly. Accordingly, Trustees tend not to consider such direct offerings, preferring instead to outsource this role to a third party specialist fund manager and make their investment, indirectly, through the manager's own pooled investment vehicle. However, we are involved in bringing together like-minded large pension funds in considering a "club" investment into infrastructure debt and have made progress on ideas in principle in this area.

Scale of resource – even investing in pooled funds specialising in infrastructure requires Trustees to "scale up" their in-house resource by ensuring they have individuals within their team with the relevant skills and experience to evaluate and monitor infrastructure investment offerings from fund managers (including being able to assess technology and regulatory requirements as well as applicable construction or operational risks). Such an initial cost hurdle in building up such specialist resources may dissuade Trustees from considering new assets classes such as infrastructure investment funds, particularly for mid-sized or smaller pension funds who will only have a relatively small allocation to infrastructure investment.

Liquidity – with most DB schemes closed to accrual and DC schemes under trust experiencing an uptick in transfer requests given the new DC flexibilities, cashflow is an increasing issue for our clients and the illiquidity of infrastructure investment makes them unattractive. Anecdotally, we are seeing a reduction in property holdings following recent challenges in realising holdings due to "gating" restrictions by property funds post-Brexit vote.

(b) Socially Significant infrastructure

The viability of making direct investments and scale of resource issue above applies with the additional barrier

(c) Other forms of social investments

No specific barriers but a lack of definition about what a social investment "is" will hinder progress.

**QUESTION 2 LEGAL AND REGULATORY BARRIERS**

**(Call for evidence, paragraph 1.15)**

**Do any of those barriers (identified in Question 1) relate to issues of law and regulation?**

Yes – some of the barriers relate to legal reasons.

A brief summary of the legal background is:

As noted above, trustees of occupational pension schemes must act in the best interests of the scheme beneficiaries which means normally acting in their best financial interests (Cowan v Scargill, 1984). It was held in that case that the power of investment "*...must be exercised so as to yield the best return for the beneficiaries*".

- In Harries v Church Commissioners [1992] 1 W.L.R 1241, the trustees were allowed to adopt an ethical investment policy which excluded 13% of the listed UK companies in order to promote the Christian faith.
- Under section 36 of the Pensions Act 1995 and the Occupational Pension Schemes (Investment) Regulations 2005, it is a legal requirement for the trustees to:

    "invest the assets in "*the best interests of the members and the beneficiaries*";

    exercise its powers of investment "*...to ensure the security, quality, liquidity and profitability of the portfolio as a whole*"; and

    invest the assets so that they are "*...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.*"

- Under section 34 of the Pensions Act 1995, trustees may delegate management of the investment assets to an investment manager but retain responsibility for the overall investment strategy. An investment manager must also comply with the requirements of section 36 above;
- Under section 36 of the Pensions Act 1995, trustees must maintain a statement of investment principles which sets out their investment policy (e.g. the expected returns), as well as any social, environmental or ethical considerations taken into account;
- In exercising their discretion to invest the scheme assets, trustees must take into account relevant factors and ignore irrelevant factors; and
- The Law Commission's report on Fiduciary Duties of Investment Intermediaries set out its view. It differentiated between "financial" factors and "non-financial" factors. In short, "financial" factors are always relevant and "non-financial" factors may be taken into account where the members' interests are aligned and there is no significant financial detriment to the scheme.

Taking the above into account, our view is that the law can act as a barrier to social investment for the following reasons:

- Social investment means different things to different people. More clarity is required on what this covers;
- Trustees are of the mindset that investments should be in the best (financial) interests of the scheme beneficiaries and ultimately its function is to generate investment returns. Trustees therefore look to their investment managers/evidence of financial returns on deciding how to invest. If there is little evidence to show that social investments produce the required returns, trustees may be reluctant to invest in these products. This is because they may feel that to do so would open themselves up to criticism/claims from the sponsoring employer/members if they produce poor investments;

- The quality and diversity of social investments available may also act as a bar to investment e.g. if funds are illiquid or difficult to understand, it may be off-putting;
- Larger funds with more resources may be more willing to allocate time to consider social investments. However small to medium funds are more likely to invest in step with the market.

**QUESTION 3: SIZE OF PENSION FUNDS**

(Call for evidence, paragraph 1.15)

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

**Yes** – the majority of our trustee clients manage funds in the sub £1bn range (with a significant proportion in the sub-£250m asset range). Schemes of that size simply do not have the resource to properly consider social investment, particularly when, in the DB field they are usually focussed on managing a deficit and, on the DC side, are simply trying to keep up with the regulatory burden.

Certain organisations have started to offer master trusts for legacy DB and DC schemes but they are attached to commercial enterprises and, in our experience, the take up has not been high. Anecdotally, we are also aware that the Pensions Regulator has expressed some concerns over the process and governance attaching to transfers to such schemes.

There is no clear legal route to such transfers (particularly without the backdrop of M&A activity or an internal reorganisation) and on any scheme transfer or merger, lawyers are left to pick through a series of challenges and issues created by the web of historic legislation and HRMC guidance. Such transfers will, for practical reasons, always need to proceed on the basis that member consent is not sought, and as such there are a number of obstacles to transfers created by the legislation that brought about the abolition of contracting-out, for example, which the DWP is yet to resolve. This means that master trust solutions tend to operate on a range of different bases each engineered to try to solve some of the difficulties presented by the legislation in a slightly different way.

The legislation on transfers (contained within The Occupational Pension Schemes (Preservation of Benefit) Regulations 1991) is clearly designed to protect the interests of members on DB to DB transfers and is simply not fit for purpose for DC to DC transfers. Specifically the requirement for actuarial certification based on comparing the rights transferred with the "transfer credits" obtained in the new scheme is extremely challenging to apply in the DC context and there is little certainty on what elements fall to be included in such a comparison (e.g. should all or any of investment choice, tax protections, fund charges, liquidity be included?)

Asset pooling in private sector pension schemes is clearly necessary to enable infrastructure and social investment on any meaningful basis in this sector. However, in our view, there would need to be (i) a clear legal route to enable such transfers using a straightforward DC-specific comparability test backed by a safe harbour approach for trustees (and overriding the myriad technical issues), (ii) the ability to transfer from occupational scheme to contract based schemes; and (iii) some financial incentive for employers of transferring schemes who will have concerns (despite the legal separation between trustees and employers) that they are giving a way control over pensions cashflows to a party that is wholly unconnected to its business. Such incentives could include, for example, additional tax deductions on contributions which relate to infrastructure/social investments.

**QUESTION 7: FINANCIAL ADVISORS AND SUITABILITY**

(Call for evidence, paragraph 1.22)

**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?**

We are not able to comment on the practice of IFAs as we do not advise or work particularly closely with IFAs ourselves. however, we are aware that occupational pension scheme trustees are under increasing pressure to give "guidance" to meres to assist in achieving "good member outcomes".

Trustees are often reluctant to stray into the field of giving guidance to members and there is a lack of clarity at law about precisely what advice or guidance trustees of occupational schemes can give to their members on investment issues. Clarity of the Trustees' role in this area (whether in law or code of practice) and, again, a safe harbour for Trustees who act in accordance with agreed principles would greatly assist in enabling the flow of information and guidance to members from Trustees (whom are usually trusted by their members and in an impartial position to compare the relative merits of receiving schemes and fund choices). We are not suggesting that Trustees take the place of IFAs or stray into the field of making recommendations, but a change in law or codes of practice to make it easier for Trustees to provide more information to their members on investment issues would assist in enabling members to explore social motivations.

**QUESTION 8: LABELLING SOCIAL INVESTMENT OPTIONS**

(Call for evidence, paragraph 1.23)

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?

A clear definition and labelling of social investment would assist our clients in taking all relevant decisions.

**QUESTION 10: LAW OF SOCIAL ENTERPRISES**

(Call for evidence, paragraph 1.25)

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?

The starting point for our clients is to make the link between social investment and members best interests and to offer relief and legal protections/exoneration where such investments underperform.

Yours sincerely

for Pinsent Masons LLP