



LAW COMMISSION OF ENGLAND AND WALES 14TH PROGRAMME OF LAW REFORM

Joint response from the Institute and Faculty of Actuaries and the Investment Consultants Sustainability Working Group

1. *In general terms, what is the problem that requires reform?*

Despite the Law Commission's previous work in this area, there is still confusion regarding the fiduciary duties of UK pension scheme trustees in relation to climate change and other environmental, social and governance (ESG) factors. This guidance and subsequent law changes impair the integration, management and stewardship of climate and ESG-related risks by trustees. In particular, the Law Commission's guidance may undermine the long-term stewardship of their assets by creating a false dichotomy between financial and non-financial factors. The distinction between the two is not clear-cut and the guidance does not provide sufficient clarity on how the terms should be interpreted. Factors which initially may not seem financial in nature may nonetheless have financial impacts, particularly over the longer-term. As a result of the confusion, trustees may not be placing sufficient emphasis on ESG factors to address the long-term risks to financial markets that stem from these factors. This may harm the long-term outcomes for pension scheme members, not to mention wider society. The Law Commission's guidance was developed in two reports, firstly in 2014 in the *Fiduciary Duties of Investment Intermediaries*¹, and secondly in 2017 in *Pension Funds and Social Investment*², resulting in changes to the law.³ The reports clarified how those who invest on behalf of others may take account of non-financial factors concluding that fiduciaries should take into account factors which are financially material to the performance of investments, including ethical or environmental, social or governance (ESG) factors. Where factors are non-financial, the reports concluded that, while the pursuit of financial return should be the predominant concern, pension trustees can base their investment decisions on these factors where two tests are met. Non-financial factors can be taken into account where trustees have good reason to think that scheme members share the concern, and where there is no risk of significant financial detriment to the fund. Despite subsequent changes to pension scheme investment regulations⁴, pension schemes are only required to state their policy on taking account of non-financial factors. This two-step process for non-financial factors creates barriers and complexity, leading fiduciaries to believe they do not need to consider these risks, and leading to calls for evidence from the Department for Work and Pensions as to the extent to which social factors are taken into account by pension schemes⁵. A recent report commissioned by the Generation Foundation, the UN's Principles Responsible Investment and the UNEP-FI produced by Freshfields Druckhaus Deringer LLP ('Freshfields II'), concluded that this two-step test

¹ <https://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/>

² <https://www.lawcom.gov.uk/project/pension-funds-and-social-investment/>

³ <https://www.legislation.gov.uk/uksi/2018/988/contents>

⁴ <https://www.legislation.gov.uk/uksi/2018/988/contents>

⁵ <https://www.gov.uk/government/consultations/consideration-of-social-risks-and-opportunities-by-occupational-pension-schemes>

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means that trustees would generally not be comfortable in taking account of non-financial factors in the UK.⁶

Given the developments in the understanding of climate and sustainability risks, alongside increased stewardship expectations and regulations since publication of the Law Commission reports, we believe these elements should be urgently reviewed:

1. The report created a false dichotomy between financial and non-financial factors. In the long run, many typically attributed non-financial factors within ESG frameworks can be considered to be financial factors. Current thinking, as evidenced in Freshfields II, is that the fundamental basis of the split between financial and non-financial is flawed. Furthermore, usage of these terms is not well defined within the financial industry. Many issues, including those relating to climate-change will have both financial and non-financial aspects. Further, some issues that start out as non-financial (e.g. public criticism in relation to a particular industry or company) may become financial (e.g. where this translates into reputational damage or reduced customer demand).
2. The reports' absence of support for stewardship are at odds with both subsequent regulations, for example, those addressing the Shareholder Rights Directive, and the general, fiduciary and societal need for better stewardship of the financial system. A function of long-term systemic risks, such as climate change, is that the fiduciary duty to manage them can only be effected through stewardship, particularly collective collaborations. The artificial distinction between financial and non-financial factors obscures the long-term financial nature of these risks, as well as the need for collaboration to address them. Although stewardship was not considered within the Law Commission's prior reports, the need for stewardship to mitigate these risks is now much more apparent.

Climate change is one of the greatest risks facing our world today. Mitigating this risk will require mobilising private finance to support the transition to a net-zero world. There is approximately £6 trillion invested in UK pensions.⁷ Undertaking reform to remove the perceived barriers which are limiting the integration and management of climate and ESG-related risks within investment decisions will be instrumental in increasing financial-flows toward green and sustainable solutions. It is also critical that asset owners are active stewards of their underlying investments to aid the transition to a low-carbon economy (see also answers to 9 and 18 below).

2. *Can you give us an example of what happens in practice? For example, if you are a solicitor or barrister, you might describe how the problem affects your clients.*

In practice, this has created confusion on the part of pension trustees about requirements to consider the integration and management of climate and other ESG-related risks in their investment decisions. The Law Commission's prior reports create a distinction between financial and non-financial factors, which is now mirrored in pension scheme investment regulations and guidance. The two-stage test, for non-financial factors does not seem workable in practice due to the difficulty in ascertaining the views of pension scheme members. Indeed, the Association of Pension Lawyers has expressed the view that there must essentially be unanimity of support among pension scheme members before non-financial factors are taken into account, other than in a tie-breaker situation. In practice, very few schemes are adopting a policy of taking account of members' views, despite growing calls (for example, from campaigns such as Make My Money Matter⁸) for pension schemes to do so.

There is an increasing number of initiatives within the financial sector aimed at promoting investment which is aligned with net zero commitments at national and international levels. For example, the Paris Aligned Investment Initiative Net Zero Asset Owner Commitment (the PAII Net zero Commitment) which contains a number of specific commitments in relation to how signatories are expected to implement net

⁶ <https://www.freshfields.com/en-gb/our-thinking/campaigns/a-legal-framework-for-impact/>

⁷ Source: Office for National Statistics – Wealth and Assets Survey

⁸ <https://makemymoneymatter.co.uk/>

zero. The perceived barriers created by the confusion over financial versus non-financial factors may prevent trustees from engaging with such initiatives.

3. To which area(s) of the law does the problem relate?

As identified in our responses to question 6 and 7, the distinction made between financial and non-financial factors in the Law Commission's reports about the Fiduciary Duties of Investment Intermediaries creates barriers to the integration and management of climate and other ESG-risks within investment decisions. The Pensions Regulator (tPR) has adopted this distinction between financial and non-financial factors within its guidance for trustees.

Further, the 2018 amendments to the *Occupational Schemes (Investment) Regulations 2005* introduced requirements for pension trustees to outline in their statement of investment principles:

1. How financially material considerations are taken into account in the selection, retention and realisation of investments; and
2. The extent (is at all) to which non-financial matters are taken into account in the selection, retention and realisation of assets.

This regulation defines financially material considerations as including (but not limited to) environmental, social and governance considerations (including but not limited to climate change), which the trustees of the trust scheme consider financially material. It defines non-financial matters as the views of members and beneficiaries including, (but not limited to) their ethical views and their views in relation to social and environmental impact and present and future quality of life of the members and beneficiaries of the scheme. This restriction of non-financial factors to views of members and beneficiaries seems narrower than in Law Commission's guidance.

As with the Law Commission's reports, we do not consider the distinction made between financial and non-financial factors made in the 2018 amendments to the *Occupational Schemes (Investment) Regulations 2005*, and tPR's guidance, to be helpful as usage of these terms is not well defined in the financial sector. Further, many issues, including those relating to climate change will have both financial and non-financial aspects.

4. Can you give us information about how the problem is approached in other legal systems?

The UNEP Finance Initiative (UNEP-FI) and the UN's Principles of Responsible Investment have led a review of fiduciary duty internationally and has recommended a re-defining of 'modern fiduciary duty'.⁹ A clearer definition of fiduciary duty, in line with the recommendation of the UNEP-FI report, would be a major enabling factor for sustainable investing within the UK and the UK could lead the way in harmonising this definition globally.

The European Union incorporates the wider definition of fiduciary duty, including non-financial factors, into its sustainability agenda from the Shareholder Rights Directive through amendments to the UCITS Directive, Solvency II, AIFM Directive, MiFID II and the Insurance Distribution Directive.

As identified in our response to 6, *A legal framework for impact: sustainability impact in investor decision-making* by Freshfields II was commissioned by the Generation Foundation, the UN PRI and the UNEP-FI and published in July 2021.¹⁰ This report creates a new term 'Investment for Sustainability Impact' (IFSI), which is intended to reflect investors' intentional attempts to impact on ESG. It focuses on differences across 11 international jurisdictions,¹¹ making a comparison of legal obligations and discretions towards

⁹ <https://www.unepfi.org/publications/investment-publications/fiduciary-duty-in-the-21st-century-final-report/>

¹⁰ <https://www.freshfields.com/en-gb/our-thinking/campaigns/a-legal-framework-for-impact/>

¹¹ Australia, Brazil, Canada, China, EU, France, Japan, Netherlands, South Africa, United Kingdom, United States

IFSI, consideration of beneficiaries' interests, stewardship, the role of investment managers, investment powers and liability to third parties.

The report found that, in facilitating IFSI, the UK is leading on some aspects and is restricting progress on others. For example, competition law may be considered overly restricted in the UK when compared to China, where exemptions may be granted where the public interest is involved. In other countries, such as Brazil and South Africa, there may be certain circumstances where explicitly prioritising sustainability goals over financial goals is permitted. Some countries explicitly permit pursuing long-term returns at the expense of short-term returns, as with the Government Pension Fund of Japan. The report also built on the UNEP-FI's review of fiduciary duty, identifying that, in Canada rulings by the Supreme Court imply a greater priority to sustainability matters in both corporate governance and pension schemes investments.¹²

5. *Within the United Kingdom, does the problem occur in any or all of England, Wales, Scotland or Northern Ireland?*

The problem occurs within all of the UK.

6. *What do you think needs to be done to resolve the problem?*

To resolve the problem, we recommend the Law Commission undertake an urgent review into the Fiduciary Duties of Investment Intermediaries with a specific focus on pensions. The review should take into consideration the developments in the understanding of climate and sustainability risks and increased stewardship expectations and regulation. The review should also consider how investors can be encouraged to consider future quality of life within their fiduciary duties. Despite this potentially being financially material, it may not be considered as part of investment decisions as it is a non-financial factor.

A key objective of the review should be to remove the distinction between financial and non-financial factors. Rather, the focus should be on investor purpose and where there is a key objective of achieving a sustainability impact goal. We suggest it incorporates the concept of 'double materiality' which is gaining traction in sustainability policy discussions. This is the idea that investors should not only factor in the impacts of social and environmental issues on their investments, but that they should also consider the impact their investment decisions have on the society and the environment. These two aspects of materiality are inter-linked: if investors exacerbate social and environmental issues, this can in turn increase the impact that the issues have on their investments. Therefore, for systemic risks such as climate change, biodiversity and inequality to be addressed effectively, investors must take account of both types of materiality. Moreover, due to their systemic nature, stewardship of assets – particularly through collective collaborations – is needed and the legal framework should support this.

7. *What is the scale of the problem?*

Pensions are a crucial investment for many UK citizens and in areas where people are especially vulnerable to the failures of financial markets. Perceived barriers which limit or discourage pension trustees from taking into account climate and ESG-related risks may ultimately mean that trustees are not acting in the best long-term interests of beneficiaries and may further exposing their savings to these risks.

Further, a nationally representative survey conducted in 2019, as part of the Government's *Investing in a Better World* initiative, found that when presented with a choice, most people in the UK would prefer their investment to consider impact on people and planet, alongside financial considerations.¹³ This was particularly the case for 18-39 year olds. However, as indicated in our response to question 7, relatively

¹² <https://www.freshfields.com/en-gb/our-thinking/campaigns/a-legal-framework-for-impact/>

¹³ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/834207/Investing-in-a-better-world-full-report.pdf

few pension trustees are investing in line with the preferences of fund members unless this is justified with reference to financial factors.

8. What would be the positive impacts of reform?

The following benefits are likely to be derived:

1. Economic benefits – The Intergovernmental Panel on Climate Change’s Special Report Global Warming of 1.5oC identified the impacts, including economic impacts, of global warming of 1.5oC above pre-industrial levels. It reported that the global aggregate impact will become significantly negative between 1oC and 2oC of warming.¹⁴ The report’s projections found there will be a further increase in the magnitude and likelihood of aggregate economic risks at 3oC of warming. Climate Economics Index stress-tests from global reinsurer Swiss Re, found that if global warming increases at its current trajectory (3.2oC of warming) the global economy could lose 18 percent of its total economic value by 2050.¹⁵ Removing barriers which prevent private finance from being invested in green solutions would go some way to addressing this. Further, if private finance can more easily be directed toward green solutions, this may reduce the level of government spending needed. This could be particularly beneficial in the wake of government spending on furlough and business support schemes during the coronavirus pandemic.
2. modernisation – delivering the review will ensure that fiduciary duties of investment intermediaries reflect developments in both climate science and regulations internationally, as well as stewardship expectations and regulations.
3. improving the simplicity of law – undertaking the review could provide clarity for pension trustees about requirements to integrate climate and other ESG risks within investment decisions.

9. If this area of the law is reformed, can you identify what the costs or other negative impacts of reform might be?

There may be a cost to pension schemes associated with ensuring that trustees have greater knowledge and understanding to enable trustees to take account of climate and sustainability considerations. However, regulations introduced by the Department for Work and Pensions already require trustees to have sufficient knowledge of climate risks to enable them to run their scheme. A review by the Law Commission is likely to provide clarity which will support trustees to meet these requirements.

10. Does the problem adversely impact equality, diversity and inclusion by affecting certain groups in society, or particular areas of the country, more than others? If so, what are those groups or areas?

Climate change affects different people and places unevenly and is likely to exacerbate inequalities within and across nations, and between current and future generations.¹⁶ Despite contributing least to causing climate change as their carbon emissions tend to be lower than other groups, low income and disadvantaged people in the UK are more likely to experience inequitable outcomes.¹⁷ Some within this group will be more exposed to the direct impacts of climate change, such as flooding or heatwaves, due to where they live. They are also likely to be more sensitive to negative effects on their health or wellbeing or have less capacity to respond.¹⁸

Policy and practice responses, such as energy policies linked to carbon reduction or flood resilience, are also likely to disproportionately impact low income and other disadvantaged people.¹⁹ Despite being less

¹⁴ <https://www.ipcc.ch/sr15/chapter/chapter-3/>

¹⁵ <https://www.swissre.com/media/news-releases/nr-20210422-economics-of-climate-change-risks.html>

¹⁶ <https://www.climatejust.org.uk/messages/why-does-climate-justice-matter>

¹⁷ <https://www.jrf.org.uk/report/climate-change-and-social-justice-evidence-review>

¹⁸ <https://www.climatejust.org.uk/messages/why-does-climate-justice-matter>

¹⁹ Ibid.

likely to benefit from these measures than high income households, they pay a higher proportion of their income towards the costs of policy responses. Further, they then to have the least voice in such decisions due to lower rates of participation in decision-making.²⁰

11. In your view, why is the independent, non-political, Law Commission the appropriate body to undertake this work, as opposed to, for example, a Government department, Parliamentary committee, or a non-Governmental organisation?

The regulatory barrier in question is created by the distinction between financial and non-financial considerations made in the Law Commission's reports, and continuing uncertainty over fiduciary duty and the extent to which climate change and social factors can be taken into account, particularly given the absence of metrics and methodologies available to measure such effects financially over the long term. As such, we believe it appropriate the Law Commission perform this urgently required review.

12. Have you been in touch with any part of the Government (either central or local) about this problem? What did they say?

The IFoA identified this issue in its response to the Environmental Audit Committee's (EAC) recent inquiry into Biodiversity and Ecosystems. In June 2021, the EAC published *Biodiversity in the UK: bloom or bust?*, informed by its inquiry. In line with the IFoA's recommendation, the EAC recommended that the Government commission a review into the Law Commission's 2014 report on the Fiduciary Duties of Investment Intermediaries, given the developments in understanding of climate and nature-related risks since the report's publication.

The Financial Reporting Council (FRC) sets expectations for investor stewardship policy and practice in the Stewardship Code.²¹ In 2019, the FRC consulted on a new Stewardship Code, which reflected significant changes in the investment industry and stewardship landscape since the 2012 revision. The IFoA responded to this consultation to highlight the important role of stewardship in managing the risks of climate and other sustainability risks. The new code, published in 2020, makes explicit reference to ESG factors.²²

13. Is any other organisation such as the Government or a non-Governmental group currently considering this problem? Have they considered it recently?

Environmental Audit Committee

As identified in our response to question 17, the EAC considered this issue as part of its inquiry into Biodiversity and Ecosystems. Its report, *Biodiversity in the UK: bloom or bust?*, was published in June 2021 and included the recommendation that the Government commission a review into the Law Commission's 2014 report on the Fiduciary Duties of Investment Intermediaries.

UNEP FI and UN PRI

As outlined in our response to question 9, the UNEP-FI and UN PRI have led an international review of fiduciary duty and recommended a re-defining of 'modern fiduciary duty'. This was a four-year programme which culminated with a major report in October 2019.

Freshfields Druckhaus Derringer LLP on behalf of UN PRI, UNEP FI and the Generation Foundation

The report produced by Freshfields Druckhaus Derringer LLP, *A legal framework for impact: sustainability impact in investor decision-making*, aims to refocus the debate from how ESG matters impact on investment decisions, to how investment decisions impact on ESG matters.²³ It creates a new term

2020 <https://www.jrf.org.uk/report/climate-change-and-social-justice-evidence-review>

2121 <https://www.frc.org.uk/investors/uk-stewardship-code>

22 Ibid

23 <https://www.freshfields.com/en-gb/our-thinking/campaigns/a-legal-framework-for-impact/>

'Investment for Sustainability Impact' (IFSI), which is intended to reflect investors' intentional attempts to impact on ESG. IFSI covers a broad range of activities, with the key objective of achieving a sustainability impact goal. It identified two different types of IFSI:

1. Instrumental IFSI where achieving the goal is 'instrumental' in realising the investor's financial goals; and
2. Ultimate Ends IFSI, where achieving the goal is a distinct goal, pursued alongside the investor's financial goals, but not wholly as a means to achieving them.

The extent to which IFSI is required or permitted is a function of not only the regulation, but also of the circumstances in which they are applied. This includes, but is not limited to, market factors, custom and practice and available data, all of which will change over time. While these factors will differ by jurisdiction, there are some broad commonalities:

1. Where financial goals are prioritised, IFSI *could* be either required or permitted.
2. Instrumental IFSI will usually be *required* where a sustainability matter provides a material risk to achieving financial goals.
3. Ultimate Ends IFSI is likely to be *permissible* in most jurisdictions, but this is likely to be in parallel to some other objective or requirement – for example to pursue an objective once a certain financial return has been achieved, or in response to the wishes of beneficiaries (The report provides examples of prohibition of certain activities inconsistent with sustainable impact goals, such as money laundering or investment in cluster munitions. However, there is much less certainty with less extreme examples.)
4. Collective Action IFSI, where investors work together to achieve a goal, is more likely to be permitted, even if the effect of an additional investor does not make a material difference to the goal. Essentially, the sum is greater than its parts, and for any one investor to benefit from a sustainable system, the system itself must be sustainable.
5. Asset Managers have clients with differing objectives, so exact alignment with Asset Owner objectives may be difficult. A broad alignment of objectives is likely to be acceptable.
6. The existence of a disclosure requirement may be a deciding factor in determining whether a particular IFSI is permitted where the law is otherwise unclear.
7. Investment theories and established practices are material factors in determining whether IFSI is permitted or required, and changes in theory and practice will result in changes as to what is permitted or required over time.

The report also concluded that neither part of the two-part test created by the Law Commission's previous report is helpful. Difficulties in achieving consensus amongst beneficiaries, and in determining what financially material, trustees would generally not be comfortable in taking account of non-financial factors in investment decision making in the UK.²⁴ It identified this as the aspect of UK law that most urgently needs review.

OECD

A recent OECD report,¹ recommended the clarification of mandates, in particular it called for regulators to clarify the relationship between fiduciary duty, duty of care and consideration of climate-related risks, noting that "...adjustments or clarifications regarding fiduciary duty would create space for willing investors to make green infrastructure investments -- investors who otherwise may be reticent due to the risk of a breach in fiduciary duty."

²⁴ <https://www.freshfields.com/en-gb/our-thinking/campaigns/a-legal-framework-for-impact/>

ShareAction

Charitable organisation, ShareAction, published its Responsible Investment Bill in 2020.²⁵ The Bill sets out a vision for a clearer and stronger role for fiduciary investors within society. It seeks to widen the idea of 'best interest', so that investors are encouraged to think about the consequences of investments on the wider economy, communities and the environment.²⁶ It also seeks to embed 'double materiality'. This is the idea that investors should not only factor in the risks of social and environmental issues on their investments, but that they should also consider the impact their investment decisions have on the society and the environment.²⁷ ShareAction is calling on Government ministers, MPs and regulators to enact the provisions within the Bill.

Should you want to discuss any of the points raised please contact Faye Alessandrello, Policy Manager (faye.alessandrello@actuaries.org.uk) in the first instance.

²⁵ <https://shareaction.org/policy-and-regulation/responsible-investment-bill/>

²⁶ Ibid.

²⁷ Ibid.