Trustee Investment Duties: ESGs and specific investments

Outer Temple

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Structure

- Trustee investment duties
- ESGs
- Non-financial factors
- Practical points

Basic Investment Duties

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Fiduciary duty of prudence (Re Whiteley)	Proper decision making process
Best interests of beneficiaries (Cowan v Scargill [1985] Ch 270	Within the rules of the trust scheme
Proper investment advice	Pensions Act 1995 and Occupational Pension Schemes (Investment) Regulations 2005

Best interests of beneficiaries

- Best financial interests?

In *Cowan v Scargill* per Robert-Megarry VC at p. 286H-287G:

> "When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests...
>
> Trustees may have strongly held social or political views…they may object to any form of investment in companies concerned alcohol, tobacco, armaments or many other things. Yet under a trust, if investments of this type would be more beneficial to the beneficiaries than other investments, the trustees must not refrain from making the investments by reasons of the view that they hold".

Stena Line [2015] EWHC 448 (Ch) per Asplin J at **[228-229]**:

> “the 'best interests of the beneficiaries' should not be viewed as a paramount stand-alone duty. In my judgment, it should not be treated as if it were separate from the proper purposes principle... It is necessary first to decide what is the purpose of the trust and what benefits were intended to be received by the beneficiaries before being in a position to decide whether a proposed course is for the benefit of the beneficiaries or in their best interests…”.

What does this mean in the context of a pension trust?

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- The purpose of that trust is to provide members with pensions:
  - Vast majority of situations this will mean best financial interests of members.
  - DB schemes: meeting the DB promise
  - DC schemes: allowing them to accumulate the best possible pot of cash at retirement.

What does best financial interests mean?

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- *Cowan v Scargill:*

"the [investment] power must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risks of the investments in question and the prospects of the yield of income and capital appreciation".

- Does not mean highest short-term returns. Risk reduction, eliminating downsides etc.

- Balancing return against risk and for any particular scheme. E.g. see reg 4(7) of the Investment Regulations on the importance of diversification of investments.

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ESGs?

- ESGs might present financial risks.
- E.g. tobacco industry, climate change, renewable energy
- Insofar as something that gives rise to a material financial risk (which could include an ESG factor) then not only can trustees take that into account when making an investment decision, but they are obliged to do so.

Non-financial factors?

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- Can non-financial factors ever be taken into account by Trustees in making investment decisions?
  - E.g. improving members’ quality of life or showing disapproval of certain industries.
- Law Commission in 2014, reiterated in 2018, took the view that in certain circumstances that a trustee could make a decision on the basis of a non-financial factor.

Law Commission 2-stage test: Law Com No 350 “Fiduciary duties of investment intermediaries”

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

(2) the decision should not involve the risk of significant financial detriment

Important to note that is an “and” not an “or” – you need to satisfy both limbs.

Palestine [2020] UKSC 16

- Lord Carnwath at **[43]**:

  "There appears now to be general acceptance that the criteria proposed by the Law Commission are lawful and appropriate. I agree. Thus administering authorities may take non-financial considerations into account –

  > '… provided that doing so would not involve significant risk of financial detriment to the scheme and where they have good reason to think that scheme members would support their decision'".

Criticisms of the two-stage test

- *Significant* financial detriment?
- *All* beneficiaries?

What does all of this mean?

(1) Financial factors, ESG or otherwise, must be taken into account.

(2) Non-financial factors can only be taken into account if they do not result in any financial detriment (i.e. essentially a tie breaker between two otherwise (on a financial basis) equal investments).

Trustee Discretion

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- Just because an investment carries material financial risk such that trustees must take it into account does not mean that the trustees should not ultimately select that investment.

- As long as all financially material risks are taken into account an investment may be selected even if it involves risk, including those associated with climate change.

- Providing it is not perverse or unreasonable.

Practical points

- ESG is distracting – financial and non-financial factors
- ESG does not automatically mean non-financial – many of them are financial
- Proper purpose and other Trustee investment duties
- Future - the Pensions Regulator draft single code:

  “When preparing their SIP, …should….take into account the types of investments scheme members prefer”.