

SOCIALLY RESPONSIBLE INVESTMENT BY CHARITIES AND PENSION SCHEMES

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1. Introduction

This article describes the respective obligations of charity trustees and pension scheme trustees to disclose their policy on socially responsible investment (“SRI”) and compares the legal considerations which they should take into account when determining and implementing that policy. The article also examines whether any special factors apply in this context to pension schemes established by charities.

2. SRI and ethical investment: problems of definition?

There is no universally accepted definition of SRI or of the older expression “*ethical investment*”. Indeed, the current Charity Commission Guidance CC14² states that SRI “*is often used as a synonym for ethical investment*”³. Consistently with that view, the relevant section of CC14⁴ has the combined heading “*Ethical*

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² “*Investment of Charitable Funds: Detailed Guidance*” (version February 2003, revised 17th February 2005)

³ *ibid* paragraph 81

⁴ Section F, paragraphs 80 to 93

and socially responsible investment” and effectively draws no distinction between the two. None the less, the increasing use of “SRI” rather than “*ethical investment*” is, as has been said, “*more than a change of nomenclature*”.⁵ The following are perhaps amongst the more important distinctions:

- (i) whereas ethical investment tends to involve negative screening to eliminate unacceptable stocks, SRI is more concerned with positive selection. For example, an SRI policy might follow a “*best in class*” strategy. This could allow investment in a sector which a traditional ethical approach might have ruled out altogether; within that sector, however, the policy would favour those companies whose policies and practices were judged to be more socially responsible than their competitors’. As Gail Moss succinctly put it:

*“Ethical means excluding specific companies; SRI means seeking out particular companies to invest in.”*⁶

- (ii) ethical investment, as a reflection of its mainly religious origins, is particularly associated with the avoidance of “sin stocks”, such as tobacco, alcohol and gambling; SRI focuses more on social issues such as environmental pollution, global warming, employment conditions and human rights.
- (iii) although an ethical investment policy seeks a financial return, it is ready to subordinate that objective to moral imperatives. In particular, it is willing to forgo the advantages of a diversification which would contravene the relevant ethical constraints. In contrast, an SRI policy might well be based on the premise that an investment strategy which takes into account social or environmental factors can produce a return equal or superior to one which does not.
- (iv) an SRI policy may be more likely than an ethical policy to pursue shareholder activism, particularly where this takes the form of constructive engagement with corporate management. This may be partly because such activity is a natural extension of positive stock selection, as distinct from avoidance. Also, an engagement strategy can be a means of promoting socially responsible corporate behaviour without sacrificing diversification. For example, it can be employed even where a fund has adopted a passive,

⁵ “*The Charitable Sector and Socially Responsible Investment: A new dawn?*” by Roger Alderson, Head of Investment Services, Charities Aid Foundation (26th March 2003) (www.cafonline.org)

⁶ “*At the crossroads*” Charity Times, September 1999

index-tracking strategy, where the sanction of disinvestment is not available.

- (v) because, for the reasons indicated above, SRI may be seen as more compatible with the objective of maximising investment performance, it can be more easily embraced by institutional investors, especially those who, like charities and pension schemes, are fiduciaries. Ethical investment, on the other hand, lends itself more readily to individual investors and to the retail funds designed to meet their requirements.

It is not suggested that these differences are either clear-cut or absolute. On the contrary, they will often be matters of emphasis or degree. Nevertheless, although the two concepts may overlap, they are still distinguishable.

As already indicated, however, there are shades of meaning not only between these two terms but also within them. The variety of practical interpretations of each expression and the differing views which exist on ethical and social questions are sometimes cited as evidence of a generic lack of clarity touching this subject. In the author's view, these criticisms are largely misconceived, as they overlook the fact that, in any particular case, a socially responsible (or ethical) investment policy can be perfectly explicit. In this context, it may be significant that the statutory provisions, regulation and guidance which govern pension schemes and charities in this respect do not attempt any general definition of SRI⁷ but, as discussed below, refer to the specific social, environmental or ethical ("*SEE*") considerations (if any) which trustees take into account when deciding their investment policy. More detailed consideration of the definition of SRI is contained in our recent book.⁸

3 Statutory and regulatory requirements

3.1 Disclosure of trustee policy on SRI

Pension schemes

Since 3rd July 2000 the statement of investment principles ("*SIP*") which pension

⁷ although the Charity Commission does draw a distinction between "*ethical or socially responsible investment*" and "*social investment*", as mentioned in section 5.2 below.

⁸ *op. cit.*, particularly in Chapter 1. See also "*Socially Responsible Investment: A Guide for Pension Funds and Institutional Investors*" by Mansley M. (Monitor Press, 2000), particularly Chapter 1, and "*Socially Responsible Investment: A Global Revolution*" by Sparkes R (Wiley, 2002), particularly pp 21 to 43.

scheme trustees must prepare under section 35 of the Pensions Act 1995⁹ (“PA1995”) has had to cover:

- “(a) *the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments; and*
- (b) *their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to investments.”*¹⁰

The second requirement is not limited to exercises of rights in relation to SEE issues but, clearly, it includes these.

Scheme trustees are obliged to make their SIPs available to their beneficiaries and to state in the scheme’s annual report whether they have prepared one and, where they have, to advise that a copy is available on request.¹¹

Charities

The regulation of charities in relation to statements of policy on SRI has been influenced by the precedents set for pension schemes. In September 2002, a

⁹ Some schemes are exempt from having to draw up a SIP. Exemptions were previously contained in The Occupational Pension Schemes (Investment) Regulations 1996, SI 1996 No 3127 (*“the 1996 Investment Regulations”*). Those regulations have, however, now been replaced by The Occupational Pension Schemes (Investment) Regulations 2005, SI 2005 No. 3378 (*“the 2005 Investment Regulations”*). The new regulations were made consequent upon, and as part of, amendments to PA 1995 made by sections 245 and 246 of the Pensions Act 2004 (*“PA 2004”*), some of which are referred to in this article. The regulations, and the related primary legislation, came into force on 30th December 2005. Under the 1996 Investment Regulations, an important category of scheme which was exempt from the requirement to have a SIP was a *“wholly-insured scheme”*, as therein defined. Under regulation 8 of the 2005 Investment Regulations, a *“wholly-insured scheme”* (the definition of which is differently worded but broadly similar in effect) must now have a SIP but this need cover only the trustees’ policy for complying with the requirements of section 36 PA 1995 (choosing investments) (see section 3.3 below) and does not have to contain a policy statement on SRI (among other matters).

¹⁰ Regulation (11A) of the 1996 Investment Regulations (as amended by SI 1999 No 3259), made under section 35(3)(f) of section 35, as originally enacted. The relevant wording of the 2005 Investment Regulations (regulations 2(3)(b)(vi) and 2(3)(c)) is virtually identical to that of the 1996 Investment Regulations. There are corresponding regulations for funds operating under The Local Government Pension Scheme (The Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998, SI 1998 No 1831 (as amended by SI 1999 No 3259)).

¹¹ Regulation 6(1) of The Occupational Pension Schemes (Disclosure of Information) Regulations 1996, SI 1996 No 1655.

Cabinet Office Strategy Unit Report¹² recommended that:

- (i) for charities with a total annual income of over £1 million, the Charities (Accounts and Reports) Regulations 2000¹³ should be amended in line with the obligations of pension fund trustees to declare what the Report termed “*their ethical investment stance*” in their annual reports;
- (ii) smaller charities with significant holdings of equities should make a similar declaration on a voluntary basis as a matter of good practice; and
- (iii) the ability of charities to follow a broad SRI policy should be clarified.¹⁴

In its response,¹⁵ the Government accepted these recommendations, deciding that the first two could be implemented through changes to the Charity Commission’s Statement of Recommended Practice (“*SORP*”) and secondary legislation and that the third had already been dealt with by the revised CC14.¹⁶

Accordingly, The Charities (Accounts and Reports) Regulations 2005¹⁷ now provide that “*where material investments are held by a charity*” the charity’s annual report must contain:

*“a description of the policies (if any) which have been adopted by the charity trustees for the selection, retention and realisation of investments for the charity, including the extent (if any) to which social, environmental or ethical considerations are taken into account.”*¹⁸

¹² “*Private Action, Public Benefit A Review of Charities and the Wider Not-for-Profit Sector*” (2002)

¹³ SI 2000 No 2868

¹⁴ Paragraph 6.14

¹⁵ “*Charities and Not-for-profits: A Modern Legal Framework The Government’s Response to “Private Action, Public Benefit”*” (July 2003)
www.homeoffice.gov.uk/docs2/charitiesnotforprofits.pdf

¹⁶ This third aspect is discussed below.

¹⁷ SI 2005 No 572. The relevant regulation came into effect on 31st March 2005.

¹⁸ Regulation 11(4)(o). This does not apply to a charity which is not subject to a statutory audit requirement (Regulation 11(8)).

The revised SORP¹⁹, which is applicable to all accounting periods beginning on or after 1st April 2005, states:

*"The report should contain a review of the financial position of the charity and its subsidiaries and a statement of the principal financial management policies adopted in the year. In particular, the report should explain ...where material investments are held, the investment policy and objectives, including the extent (if any) to which social, environmental or ethical considerations are taken into account."*²⁰

Thus the statutory instrument closely follows its pensions counterpart in relation to stock selection but contains nothing relating to disclosure of policy on the exercise of rights attaching to investments. Likewise, although the wording of the SORP is, arguably, wider, it also makes no express reference to this. For explicit guidance on this question, charity trustees must look to CC14. This describes the requirements applying to pension schemes including, specifically, that relating to trustee policy on the exercise of rights attaching to investments. It then refers to the Strategy Unit's recommendation that "similar disclosures" be contained in the annual reports of all charities even where there is no legal requirement to do so and states:

*"Whilst there is, at present, no legal requirement on any charity trustees to do this, it would be good practice to include such information in the charity's annual report".*²¹

As already indicated, CC14 was issued before the Strategy Unit's recommendations were implemented. It appears, however, that insofar as there is still no legal obligation for trustees to include in their annual report a statement of their policy (if any) on the exercise of rights attaching to investments, they should none the less do so, in accordance with CC14.

¹⁹ Charity Commission, "Accounting and Reporting by Charities: Statement of Recommended Practice (revised 2005)" March 2005; (www.charity-commission.gov.uk/publications/pdf/sorp05text.pdf). Paragraphs 430 to 448 explain how charities should account for retirement benefits having regard in particular to the effect on defined benefit schemes of Financial Reporting Standard 17, which is fully effective for accounting periods starting on or after 1st January 2005 and, inter alia, requires employers to recognise a surplus or deficit in such schemes as an asset or liability in the employer's accounts.

²⁰ Paragraph 55(d). Paragraph 56 confirms that this does not apply to charities not subject to statutory audit.

²¹ Paragraphs 92 and 93.

Aside from requirements affecting the annual report, CC14 strongly recommends that trustees decide on an investment policy and record it in writing.²² As CC14 reminds trustees, the preparation of a policy statement is in any case a legal requirement where the trustees delegate to an investment manager under the Trustee Act 2000 (“TA”).²³ Among the considerations which, according to CC14, any investment policy should address is

*“the charity’s stance on ethical investment (if any)”*²⁴

The above requirements effectively compel trustees of pension schemes and charities to decide their policy towards SRI. We now turn to the principles which should guide each category of trustees in making that decision.

3.2 The relevant standard of care

Pension schemes

PA 1995 contains a discrete code which regulates pension fund investment.²⁵ For that reason, the provisions of TA, including the statutory duty of care referred to below, do not apply to occupational pension schemes to the extent, broadly, that they relate to the trustees’ investment functions.²⁶ There is, however, no equivalent

general duty of care specified in PA 1995.²⁷ The standard of care applicable to pension scheme trustees therefore remained that established by case law, i.e. to

²² Paragraph 117

²³ Section 15(2)(a). See section 3.4 below.

²⁴ Paragraph 118

²⁵ In particular, section 34(1) of PA 1995 anticipated section 3(1) of TA by conferring on pension scheme trustees the same power to make an investment of any kind as if they were absolutely entitled to the assets of the scheme. This gave scheme trustees much wider statutory powers than those which they already had under the Trustee Investments Act 1961 (“TIA”). The power under PA 1995 is subject to any restriction imposed by the scheme; this again foreshadowed TA (section 6(1)(b)), although under TA any restrictions contained in instruments made before 3rd August 1961 (when TIA came into effect) are not to be treated as restricting or excluding the general power of investment (section 7(2)). In practice, most pension schemes and charities had express provisions giving wide investment powers, so in both cases these legislative changes were less radical than might appear.

²⁶ Section 36 of TA

²⁷ contrary to the recommendation in the report of the Pensions Law Review Committee, chaired by Professor Goode (September 1993) (*“the Goode Report”*)

*"take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide".*²⁸

This "ordinary prudent man" is, moreover, an ordinary prudent man of business.²⁹ An even higher standard is expected of a professional trustee.³⁰

The Pensions Act 2004 ("PA 2004") likewise does not lay down a general new standard of care.³¹ It does, however, require trustees to have "knowledge and understanding" of certain specified matters.³² These include obligations to be conversant with the scheme's current SIP³³ (and thus with its required statement on SRI) and to have "knowledge and understanding of ... the principles relating to ... investment of the assets of [occupational pension schemes]".³⁴ It seems likely that the effect of these provisions, coupled with the related code of practice which the Pensions Regulator (established under the Act) is obliged to issue,³⁵ will be to raise the level of expertise which scheme trustees are expected to bring to bear on investment matters, including SRI.³⁶

Under section 33 of PA 1995, liability for breach of an obligation under any rule of law to take care or exercise skill in the performance of any "investment functions" cannot be excluded or restricted by any instrument or agreement where the function is exercisable by a scheme trustee (or by anyone to whom the function

²⁸ *Re Whiteley, Learoyd v Whiteley* (1886) 33 Ch D 347 (CA) at 355

²⁹ *Ibid* referring to *Speight v Gaunt* (1883) LR 22 Ch D 727 (CA), affirmed by *Speight v Gaunt* (1883-84) LR9 App Cas 1 (HL)

³⁰ *Bartlett v Barclays Bank Trust Co Ltd* [1980] 1 All E R 139

³¹ again, despite a further recommendation to this effect by Mr Paul Myners in his report ("*Institutional Investment in the United Kingdom: a Review*" (March 2001) ("*the Myners Report*") (Chapter 2, paragraph 2.31)). The Act, and regulations under it, do, however, reflect the "prudent person" principle of the Occupational Pensions Directive; see footnote 40.

³² Sections 247 to 249.

³³ Section 247(3).

³⁴ Section 247(4)

³⁵ under section 90(2)(f). The code is expected to come into force on 6th April 2006. A draft code and related documents appear on the Pension Regulator's website (www.thepensionsregulator.gov.uk).

³⁶ A fuller discussion of these new provisions is included in our book op.cit. at pp 114 to 121.

has been delegated under the statutory power of delegation conferred by section 34³⁷). Thus any provision in the scheme's trust deed which purports to lower the generally applicable standard of care in this respect will be ineffective.

Charities

In their exercise of powers of investment, charity trustees are subject to the general duty of care in section 1 of TA. This requires trustees to invest with such care and skill as is reasonable in the circumstances, having regard to any special knowledge or experience that the trustee has or holds himself out as having, and, where they act as a trustee in the course of a business or profession, any special knowledge or experience that is reasonable to expect of a person so acting. The statutory duty of care can be excluded by the trust instrument.³⁸

The Law Commission Report "*Trustees' Powers and Duties*" makes it clear that TA is not intended to apply to directors of charitable companies, on the basis that they are not trustees.³⁹ They are therefore subject to the common law standard of care of "*the ordinary prudent man of business*".

3.3 Diversification and suitability of investments

Pension schemes

Section 36 of PA 1995, as originally enacted, required trustees, or their fund managers, to have regard to the need for diversification of investments and to the suitability of investments in terms identical to the standard investment criteria in section 4 of the TA, which apply to charities (see below). Section 245 of PA 2004, however, amends section 36 so as to require trustees and fund managers to exercise their investment powers in accordance with regulations and provides that such regulations may, in particular, specify criteria to be applied in choosing investments and require diversification of investments.

³⁷ See section 3.4 below.

³⁸ Section 2 and Schedule 1, Paragraph 7.

³⁹ This, however, is not wholly free from doubt; see e.g. "*The Trustee Act 2000 – Points in Practice for Charities*" by Robert Meakin, *Private Client Business* 2001 Issue 3.

The 2005 Investment Regulations⁴⁰ provide, among other matters, that the investment powers must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of “*the portfolio as a whole*”, that the assets of the scheme must be invested predominantly on regulated markets and that they must be 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.

Charities

By virtue of section 4 of TA, in exercising any power of investment, charity trustees⁴¹ must have regard to the “*standard investment criteria*” and must from time to time review the trust investments and consider whether, having regard to the criteria, they should be varied. The criteria, in relation to a trust, are

- “(a) *the suitability to the trust of investments of the same kind as any particular investment proposed to be made or retained and of that particular investment as an investment of that kind, and*
- (b) *the need for diversification of investments of the trust, in so far as is appropriate to the circumstances of the trust*”.

In this regard, CC14 states:

“Where a charity has an ethical or socially responsible investment policy..., the duty to consider suitability involves recognising the need for consistency with that policy”.⁴²

CC14 also reminds trustees who have adopted an ethical investment policy that they must discharge all the normal duties of trustees in this regard and that

⁴⁰ Regulation 4. One of the purposes of the regulations is to implement certain requirements of the Directive of the European Parliament and of the Council of 3rd June 2003 (2003/41/EC) on the activities and supervision of institutions for occupational retirement provision (OJ L 235/10, 23rd September 2003) (“*the Occupational Pensions Directive*”). The Directive adopted the “*prudent person*” principle in relation to scheme investment, which necessitated some amendments to existing UK regulation. Regulation 4(2)(a) gives effect to the requirement in Article 18(1)(a) of the Directive that assets be invested “in the best interests of members and beneficiaries”. There is thus no express restriction to purely financial best interests; see the discussion in sections 4 and 5.2 regarding whether and how trustees may take into account their beneficiaries’ non-financial interests when determining investment policy.

⁴¹ which, again, does not include directors of charitable companies (see above).

⁴² Paragraph 56

*“[i]n particular, they must consider the need for diversification [and must take advice where appropriate]”.*⁴³

There might appear to be a significant difference between, on the one hand, the duty of charity trustees to have regard to a proposed investment’s particular, as well as generic, suitability and, on the other hand, the more holistic approach which pension scheme trustees are now required to adopt under the 2005 Investment Regulations. It seems, however, that the courts would interpret the TA’s standard investment criteria in accordance with modern portfolio theory, which judges the suitability of specific investments by reference to the totality of the holdings within the fund.⁴⁴

3.4 Exercise of Investment Powers: Advice and Delegation

Pension Schemes

Section 35 PA 1995⁴⁵ provided that before preparing or revising their SIP, scheme trustees must

“obtain and consider the written advice of a person who is reasonably believed by the trustees to be qualified by his ability in and practical experience of financial matters, and to have the appropriate knowledge and experience of the management of the investments of such schemes”

As the SIP has to cover the trustees’ stance on SRI, the trustees should ensure that the investment consultant whom they appoint for this purpose has the requisite expertise to advise them on that subject.

As to the implementation of the SIP, for most practical purposes the trustees will normally need to delegate investment decisions to a fund manager who is an authorised person under the Financial Services and Markets Act 2000 (“FSMA”).

⁴³ Paragraph 84

⁴⁴ *Nestle v National Westminster Bank plc* [1992] NPC 68 and 1996 10TLI 112; affirmed [1993] 1WLR 1260 (CA) and [1994] 1 All ER 118 where the main issues were (1) whether the Bank, as trustee, should have invested more of the trust funds in equities rather than in gilts, and (2) the consequences of the Bank’s mistakenly restrictive interpretation of the classes of equities in which it was permitted to invest; the focus was not on individual investment decisions.

⁴⁵ Subsection (5)(a) of the original section. Under the new section 35, as substituted by section 244 PA 2005, the same wording is contained in regulation 2(2)(a) of the 2005 Investment Regulations.

That is because, unlike other trustees, the trustees of an occupational pension scheme are⁴⁶ generally to be regarded as carrying on the regulated activity of managing investments, unless all “*day to day decisions*” regarding the scheme’s “*securities*” or “*contractually based investments*”⁴⁷ are delegated to someone who is an authorised person⁴⁸ in relation to that activity.⁴⁹

Scheme trustees have the power to make such a delegation under section 34(2)(a) of PA 1995. Where they have done so, section 34(4) provides that they are not responsible for the acts or defaults of the fund manager if either they or the person who appointed the fund manager on their behalf have taken all reasonable steps to satisfy themselves

- “(a) *that the fund manager has the appropriate knowledge and experience for managing the investments of the scheme; and*
- (b) *that he is carrying out his work competently and complying with section 36.*”

If, therefore, the trustees have stated in their SIP that their policy is to take SEE considerations into account in relation to either the choice of investments or the exercise of shareholder rights, they should assess the expertise of any potential fund manager in this regard. Once a fund manager has been appointed, the trustees should also monitor its performance and activities against the scheme’s SRI policy. In the latter respect, the reference to the fund manager’s “*complying with section 36*” imports the requirement in section 36(5) that

“[t]he trustees, or the fund manager to whom any discretion has been delegated under section 34, must exercise their powers of investment with a view to giving effect to the principles contained in the statement under section 35, so far as is reasonably practicable.”

⁴⁶ by virtue of regulation 4 of The Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order, SI 2001 No 1177, as amended by SI 2005 No 922

⁴⁷ as defined, in each case, in SI 2001 No 1177

⁴⁸ more precisely, an authorised or exempt person or an “*overseas person*”, as defined in The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, SI 2001 No 544

⁴⁹ Absent such delegation, the trustees would risk committing a criminal offence under section 23 of FSMA, unless they were themselves authorised.

Scheme trustees are therefore under a specific statutory obligation to try to ensure that any SRI policy in their SIP is properly implemented. They are also exposed if they fail to do so and if loss results. This is because if they cannot claim the protection of section 34(4), section 33 will mean that they will be unable to rely on any exoneration clause or right of indemnity out of scheme assets which may be in their trust deed.⁵⁰

Where trustees are exercising their investment powers themselves, section 36(3) PA 1995⁵¹ provides that, before investing, they must obtain and consider “*proper advice*” on whether the investment is satisfactory, having regard to, amongst other matters, the principles contained in their SIP. They must also determine when it is desirable to obtain and consider such advice in relation to retained investments.⁵²

For this purpose, “*proper advice*” is defined in subsection (6):⁵³ where giving the advice will constitute carrying on a regulated activity by way of business under the FSMA, it means, broadly, advice given by an authorised fund manager; in any other case, it means advice given by a person who meets the same criteria as must be met by the person from whom trustees must obtain advice before preparing or revising their SIP (see above). In either case, trustees should make sure that the person whom they select is competent to advise on any principles in their SIP which concern SRI.

One of the circumstances in which the “*proper advice*” requirement will be relevant is where the trustees of a defined contribution scheme are deciding which investment options to offer to their members⁵⁴ and are considering the inclusion of one or more ethical, green or other socially responsible options. The trustees of a defined benefit scheme may have a similar choice to make in respect of money purchase investment options for their members’ additional voluntary contributions. Even where a scheme is “*wholly-insured*” and thus not required to include a policy statement on SRI in its SIP,⁵⁵ the trustees should satisfy themselves that their adviser has the requisite knowledge of SRI to advise them in this respect.

⁵⁰ See section 3.2 above. This is on the assumption that the appointment and monitoring of a fund manager are “*investment functions*” for the purposes of section 33, which, in the author’s view, they are. (The expression is not defined in the Act.)

⁵¹ both as originally enacted and as amended by section 245 PA 2004

⁵² Section 36(4)

⁵³ as amended by The Financial Services and Markets Act 2000 (Consequential Amendments and Repeals) Order SI 2001 No 3649

⁵⁴ N.B. Even though the members may request or instruct the trustees to invest in a particular fund, it will still be the trustees, not the members, who will be doing the investing.

⁵⁵ See footnote 9.

Trustees will need to consider whether any ethical option which they might provide is a suitable and prudent addition to the choices offered to members. They should not assume that merely because a member may have requested or directed them to invest in the fund he or she will necessarily be estopped from complaining subsequently.⁵⁶

Charities

As they are subject to TA 2000 in relation to their investment functions, charity trustees, before exercising any power of investment, must obtain and consider “proper advice” about the way in which, having regard to the standard investment criteria, the power should be exercised.⁵⁷ The same requirement applies when the trustees are reviewing the trust’s investments.⁵⁸ The trustees need not obtain such advice if they reasonably conclude that in all the circumstances it is inappropriate for them to do so.⁵⁹ “proper advice” is defined as:

*“the advice of a person who is reasonably believed by the trustee to be qualified to give it by his ability in and practical experience of financial and other matters relating to the proposed investment”*⁶⁰

In this context, CC14 states that:

*“what is a suitable qualification for the adviser will depend on the extent and nature of the assets available for investment”*⁶¹

From the statutory reference to “the proposed investment”, however, it seems clear that the qualification must relate also to the nature of future investments, so that where the selection of these is to be influenced by SEE considerations, the adviser should be competent in that regard. This is consistent with CC14’s

⁵⁶ The potential exposure of scheme trustees in this regard is considered in more detail in our book, op cit particularly in section 4.6. Here again, it is submitted that the selection of investment funds to offer to members is an “investment function” for the purposes of section 33 of PA 1995.

⁵⁷ Section 5(1) TA

⁵⁸ Section 5(2)

⁵⁹ Section 5(3). For examples of when a trustee might reasonably take this view, see CC14, paragraphs 52 and 53.

⁶⁰ Section 5(4)

⁶¹ Paragraph 60

guidance on “suitability” in the context of an SRI policy, referred to in section 3.3 above.

Unlike pension scheme trustees, charity trustees or the directors of a charitable company are not obliged by statute to seek advice from a properly qualified person before preparing or revising an investment policy statement. Their governing instrument,⁶² however, may do so and most modern ones will require this. Moreover, CC14 states that trustees “*may well find it helpful*” to take independent expert advice in these circumstances.⁶³

Where trustees are about to delegate investment decisions to a fund manager, and therefore have to draw up an investment policy statement, CC14 recommends⁶⁴ that they do this in consultation with the proposed investment manager, in view of the requirement in section 15 (2)(b) of TA that the investment management agreement must include:

“a term to the effect that [the manager] will secure compliance with ..the policy statement”.

This wording is therefore stricter than the corresponding provision in section 36(5) of PA 1995, quoted above.⁶⁵

In this context, CC14 states:

*“It is important that the charity’s stance on ethical investment is explained to the investment manager in a way that enables the manager to give proper effect to it....If the trustees do not define the criteria with sufficient precision, then there is the danger that the manager will either select investments which are incompatible with the charity’s ethical stance, or will unnecessarily avoid particular types of investment.”*⁶⁶

This approach differs from that prescribed for pension schemes in that the person whose advice scheme trustees will seek when preparing their SIP will typically be

⁶² whether a trust deed or a memorandum and articles of association

⁶³ Paragraph 138

⁶⁴ Paragraph 139

⁶⁵ as, indeed, is the equivalent requirement under The Local Government Pension Scheme, which is that the manager “*must not make investments which would contravene...the statement*” (Regulation 7, SI 1998 No 1831 (as amended by SI 1999 No 3259)).

⁶⁶ Paragraph 148

an investment consultant, e.g. an actuary, rather than a fund manager. None the less, scheme trustees should also discuss in advance with their fund managers how any SRI strategy in their SIPs would be put into practice. In any case, such discussions ought to be a natural part of the process by which the trustees satisfy themselves that a prospective fund manager has the requisite expertise in SRI.

4. Case Law

Pension Schemes

The leading case on SRI by pension schemes is *Cowan v Scargill*.⁶⁷ The case concerned the Mineworkers' Pension Scheme. The scheme had ten trustees, of whom five were appointed by the National Coal Board ("*the NCB*") and five by the National Union of Mineworkers ("*the NUM*"). A dispute arose when the NUM-appointed trustees sought to amend the scheme's investment policy so as to cease all further investment overseas, to withdraw all existing such investment at an opportune time and to end all further investment in any energy industries which were in direct competition with coal. These amendments reflected NUM policy. The trustees had wide investment powers, which authorised them to invest in all the ways which the NUM-appointed trustees wished to prevent. As the dispute could not be resolved, the NCB-appointed trustees applied to the court for directions whether the NUM-appointed trustees were, by their stance, in breach of their fiduciary duties.

The main points contained in the judgment of Sir Robert Megarry V-C, ("*the Megarry judgment*") were as follows:

- (i) trustees must exercise their powers in the best interests of their beneficiaries. When the purpose of the trust is to provide financial benefits for the beneficiaries, their best interests "*are normally their best financial interests*"⁶⁸. A power of investment, therefore, must be exercised so as to yield the best risk-adjusted return.
- (ii) a corollary is that, when investing, trustees must put on one side their own personal interests and views, including any social or political views. Trustees may even have to act dishonourably (though not illegally).⁶⁹

⁶⁷ [1984] 2 All ER 750, (1985) Ch 270

⁶⁸ *Ibid* page 760

⁶⁹ Sir Robert referred to *Buttle v Saunders* [1950] 2 All E R 193 (where trustees were held to be under a duty to "gazump" in the interests of their trust).

- (iii) this does not mean that the benefit of the beneficiaries which trustees must make their paramount concern “*inevitably and solely means their financial benefit, even if the only object of the trust is to provide financial benefits*”⁷⁰. If, for example, all the actual and potential beneficiaries of a trust were adults and had strict views on moral and social matters, it might well be for their benefit if the trust fund were invested in a way which resulted in their receiving less than they would have received from investment in what they regarded as “*evil and tainted sources*”.⁷¹ Such cases, however, are likely to be “*very rare*” and “*under a trust for the provision of financial benefits the burden would rest, and rest heavy, on him who asserts that it is for the benefit of the beneficiaries as a whole to receive less by reason of the exclusion of some of the possibly more profitable forms of investment*”⁷²
- (iv) in exercising their powers of investment, trustees must observe the “*ordinary prudent man*” standard of care established in *re Whiteley*⁷³. That duty includes the duty to seek advice on matters which the trustee does not understand, such as the making of investments. Although a trustee is not obliged to accept and act on that advice, he is not entitled to reject it, unless, in addition to sincerely disagreeing with it, he is acting as an ordinary prudent man would act.⁷⁴
- (v) trustees have a duty to consider the need for diversification of investments.⁷⁵ There was no evidence that it would be beneficial to the scheme to be shorn of its ability to invest overseas.
- (vi) the above principles were originally laid down in the context of private trusts but they apply equally to pension schemes. Indeed, the large size of pension funds only increases the need for diversification, and the fact that much of the fund had been contributed by the members to secure their pensions made it all the more important that the interests of the

⁷⁰ Page 761

⁷¹ *ibid*

⁷² Page 762

⁷³ See section 3.2 above

⁷⁴ Page 762

⁷⁵ The Vice-Chancellor referred to section 6(1) of TIA, which is similar in effect to the standard investment criteria of suitability and diversification contained in section 4 of TA. (See section 3.3 above, which also details the corresponding statutory provisions now governing pension schemes.)

beneficiaries should be paramount. There was no justification for their benefits to run the risk of being lessened because the trustees were pursuing an investment policy intended to assist the industry that the pensioners had left, or their union.

Developing the last of the above points, Sir Robert considered it relevant that the scheme was fully funded, so the future payment of benefits was not, in the main, dependent upon the general prosperity of the coal industry. Any policy designed to ensure this prosperity could not be regarded as one directed to obtaining the best possible results for the beneficiaries, most of whom were no longer engaged in the industry and some of whom never had been. The connection was "*far too remote and insubstantial*". Further, the assets of even so large a pension fund were nowhere near the size at which there could be expected to be any "*perceptible impact*" from the adoption of the proposed policies.⁷⁶

Likewise, any possible benefits from imposing the restrictions which might accrue to the beneficiaries, as distinct from the general public, were far too "*speculative and remote*"; although the fund was large, the restrictions could not "*make any material impact on the national economy, or bring any appreciable benefit to the beneficiaries*".⁷⁷

For many years, *Cowan v Scargill* was widely understood as having established that pension schemes should not engage in SRI. In the author's view, however, that perception arose from too wide an interpretation of the *Megarry* judgment and too narrow an understanding of SRI. This issue is considered below (principally in section 5.2) and is examined in greater detail in our book⁷⁸

Charities

There are two important cases on SRI which involved charitable trusts. Both were decided after *Cowan v Scargill*. The first is a Scottish case (which therefore has persuasive authority in the English courts): *Martin v City of Edinburgh District*

⁷⁶ Page 764

⁷⁷ Page 767

⁷⁸ *op cit*, section 4.3. Support for this view was expressed in Freshfield Bruckhaus Deringer's report "*A legal framework for the integration of environmental, social and governance issues into institutional investment*", produced for the Asset Management Working Group of the United Nations Environment Programme Finance Initiative (UNEP FI) (October 2005); pages 88 – 90, 96-97 & 101. The report, which contains a comprehensive survey of the current legal position in several common law and civil law jurisdictions, can be read on the UNEP FI website (<http://www.unepfi.org/investment/>).

*Council*⁷⁹. When the Labour Party won control of Edinburgh District Council in 1984, they adopted a policy of opposition to apartheid and took steps to withdraw investments from companies which had links with South Africa. The Council administered a number of different funds on trust for various public and charitable purposes. An elected member of the Council sued it on the grounds that it was acting in breach of trust because it had implemented or proposed to implement the disinvestment policy in relation to these funds without having considered or obtained professional advice on the question of whether the policy was in the best interests of their beneficiaries.

The Court held that the Council had misdirected itself in the way alleged and that that was sufficient to establish a breach of trust. In his judgment, however, Lord Murray went on to make some observations on the principles which had been argued in the case by reference to the *Megarry* judgment. First, he considered that the principle that, in a trust to provide financial benefits, the duty to secure the best financial interests of the trust included a duty to invest the trust assets to the best financial advantage should not be taken to mean that trustees have an unqualified duty simply to invest the trust funds in the most profitable investment available; that would involve substituting the judgment of financial advisers for that of trustees.

Secondly, although he agreed that trustees should not fetter their investment discretion by reasons extraneous to the trust purpose, including reasons of a political or moral nature and matters of conscience, Lord Murray did not think it reasonable or practicable to expect a trustee, when genuinely applying his mind and judgment to a trust decision, to “*divest himself of all personal preferences... political beliefs, and ... moral, religious or other conscientiously held principles*”. Instead, a trustee should recognise that he has those preferences, commitments or principles but none the less do his best to exercise fair and impartial judgment on the merits of the issue before him. If he realises that he cannot do that then he should abstain from participating in deciding the issue or, in the extreme case, resign.

Although the *Martin* case concerned charitable trusts, Lord Murray did not distinguish it from *Cowan v Scargill* on that ground. Such a distinction was, however, made in the leading case on SRI by charities, *Harries and others v The Church Commissioners for England*⁸⁰ (“*the Bishop of Oxford’s case*”). The Bishop of Oxford and others challenged the Church Commissioners (a charity providing financial assistance to Church of England clergy) by seeking declarations that when investing assets they needed to have regard to their duty to promote the

⁷⁹ (1988) SLT 329

⁸⁰ [1993] 2 All ER 300, [1992] 1 WLR 1241

Christian faith through the established Church of England and that they should not exercise their investment functions in a manner incompatible with that purpose even if it were financially detrimental not to do so.

In his judgment, Sir Donald Nichols V-C drew a distinction between property held by trustees for functional purposes (such as the Salvation Army's hostels) and that held as an investment for the purpose of generating money to further the work of the charity. Where funds are held as an investment, in most cases it will be in the charity's best interests for the investment to be made on well-established investment criteria, having taken expert advice where appropriate and having regard for the need to diversify, the need to balance income against capital growth and the need to balance risk against return. Sir Donald then set out some exceptions where the position would not be so straightforward:⁸¹

- (i) in some circumstances, the duty of the trustees is to avoid certain investments because they conflict with the objects of the charity; much-cited examples were cancer charities and tobacco shares, trustees of temperance charities and brewery shares, and Society of Friends' trustees and armaments shares. Logically, trustees should take this course even if it would be likely to result in significant financial detriment to the charity. In practice, however, the application of this principle would be unlikely to leave trustees without an adequately wide range of investments from which to choose a properly diversified portfolio.
- (ii) there would be some cases, which, again, Sir Donald suspected would be comparatively rare, when trustees' holdings of a particular investment might hamper a charity's work either by making potential recipients of aid unwilling to be helped because of the source of the charity's money, or by alienating some of the charity's financial supporters. In such cases, the trustees would need to balance the difficulties they would encounter from holding the investments against the risk of financial detriment if they excluded them.
- (iii) there will be instances where supporters or beneficiaries of a charity take different views on whether a particular investment conflicts morally with the charity's aims. On many such moral issues, there are no certain answers. If that situation confronts the trustees of a charity, "*the law does not require them to find an answer to the unanswerable*". In such circumstances, trustees may, if they wish, accommodate the views of objectors but only if they are satisfied that to do so would not involve "a

risk of significant financial detriment". This condition applies even where one view is more widely supported than another.

- (iv) the charity's trust deed might entitle, or require, trustees to take non-financial criteria into account.

Sir Donald observed that the Church Commissioners already had an "*ethical*" investment policy. This stated that the primary aim was total financial return but that "*as responsible investors we also continue to take proper account of social, ethical and environmental issues*". The policy prohibited investment in companies whose main business was in certain specified sectors, which included armaments, gambling, alcohol and tobacco. Further, the commissioners did not invest in any South African company nor in any other company which had more than a small share of its business in South Africa. This excluded about 13% (by value) of listed UK companies from consideration. Sir Donald considered that there was nothing in the policy which was inconsistent with the general principles which he had expounded.⁸²

The Bishop of Oxford's council had called for a more restrictive policy on South Africa. This would have increased the total exclusion to about 37%, with even higher percentage exclusions in certain key sectors of the portfolio. Neither policy, however, involved the exclusion of every company which had a South African connection. The difference between them was one of degree only and the question of whether Christian ethics required a more restrictive policy fell into the unanswerable category. The commissioners were therefore right not to prefer one view over the other beyond the point at which they would incur a risk of significant financial detriment.⁸³

As to the potential differences between charitable trusts and pension schemes in this regard, Sir Donald commented

*"I have sought...to consider charity trustees' duties in relation to investment ... My attention was drawn to Cowan v Scargill ..., a case concerning a pension fund. I believe the views I have set forth accord with those expressed by Megarry V-C in that case, bearing in mind that he was considering trusts for the provision of financial benefits for individuals. In this case I am concerned with trusts of charities, whose purposes are multifarious."*⁸⁴

⁸² Page 307

⁸³ Page 309

⁸⁴ Page 305

The extent to which the particular considerations listed by Sir Donald in relation to charitable trusts might have counterparts in the context of pension schemes is discussed below (in section 6).

5. Reasons for an SRI Policy

5.1 Increased investment returns

As already indicated, one of the characteristics of SRI is a belief in the potential of SEE considerations to contribute to investment performance. As CC14 observes:

*“An ethical investment policy may be entirely consistent with ... [the] principle of seeking the best returns. For example, there is an increasingly held view that companies which act in a socially responsible way are more likely to flourish and to deliver the best long term balance between risk and return.”*⁸⁵

This view, which applies both to stock selection and to the exercise of shareholder rights, is one of the most important dimensions of SRI for trustees to take into account. Indeed, trustees who fail to consider it may well be in breach of their fiduciary duty of prudence. As Hoffmann J observed, albeit in a different context, in *Nestle v National Westminster Bank plc*⁸⁶, the “ordinary prudent man of business” principle is “an extremely flexible standard capable of adaptation to ... contemporary understanding of markets and investments”⁸⁷

The Court of Appeal judgment in the same case, which upheld Hoffmann J’s decision, contained similar sentiments:

*“what the prudent man should do at any time depends on the economic and financial conditions of that time – not on what judges of the past, however eminent, have held to be the prudent course in the conditions of 50 or 100 years before”.*⁸⁸

⁸⁵ Paragraph 84

⁸⁶ [1992] NPC 68 and 1996 10 TLI 112; affirmed [1993] 1WLR 1260 (CA) and [1994] 1 AllER 118

⁸⁷ 1996 10 TLI 112 at 115.

⁸⁸ [1994] 1 AllER 118 per Dillon LJ at 125

Trustees should therefore ensure that they, and their investment advisers and fund managers, are abreast of current thinking and practice in this regard.⁸⁹

Despite its significance, this aspect of SRI will not be discussed further in this article since the considerations which pertain to it are common to both charities and pension schemes⁹⁰ and there is thus not much to say by way of comparison.⁹¹ It should be noted, however, that the possible financial benefits of SRI did not fall to be considered in depth in any of the three cases referred to in the previous section; those cases therefore have little relevance in this respect.

5.2 Other reasons

Pension schemes

Apart from any potential to improve investment performance, SEE considerations may be relevant in other ways to the provision of financial benefits under a pension scheme, through a more general promotion of the purposes of the scheme.

Most obviously, trustees should take into account how their policy on SRI may affect the sponsoring employer. The interests of the scheme are usually closely linked to those of the employer. Unless there are no active members (and so no future service benefits) and no discretionary benefits and unless the scheme has the resources to provide benefits in full on a winding up, the future prosperity of the employer is of the utmost importance.

The employer is usually a contributor to the scheme and, in the case of a defined benefit arrangement, is a guarantor of benefits. Regulations made under PA 1995,

⁸⁹ There is a great deal of relevant information in the public domain, including the websites of leading pension schemes, fund managers, and investment consultants. Several examples are given in our book *op cit*, in particular in Appendix 2. One of the websites which is particularly concerned with the potential contribution of SRI to long-term investment performance is www.enhancedanalytics.com; its research is aimed at identifying “*extra-financial issues*”, which it defines as “*fundamentals that have the potential to impact companies’ performance in a material way, yet are generally not part of traditional fundamental analysis*”. See also the UKSIF website and that of EIRIS (Ethical Investment Research Service) (www.eiris.org).

⁹⁰ save, perhaps, where a charity’s investment objectives are short-term. Almost by definition, a pension scheme’s objectives will be long-term. Highly mature closed schemes may be an exception but these will in any case probably be invested wholly or mainly in gilts, which offer little or no scope for SRI.

⁹¹ This issue is, however, dealt with in some detail in our book *op cit*.

as amended by PA 2004,⁹² have strengthened the obligations of employers in this respect: broadly, on a winding up, an employer is liable for any deficiency on a full “buy-out” basis i.e. on the assumption that liabilities for pensions or other benefits will be discharged by the purchase of annuities.

More fundamentally, the employer usually embodies the undertaking which provides the employment that is the substratum of the scheme. The American case of *Withers v Teachers' Retirement System of the City of New York*⁹³ illustrated that trustees could be justified in taking investment decisions which would not otherwise be prudent⁹⁴ in order to assist the employer and thus to safeguard the benefits under the scheme. Indeed, there are currently many schemes where the only hope of their being able to provide the benefits in full is for the employer to continue in business so that the scheme can also continue and the employer can repair the deficit over time.

As emphasised in *Cowan v Scargill*, trustees must not too easily equate the interests of the employer with those of the scheme, especially where many of the beneficiaries no longer have (or may never have had) any connection with the employer's business or where the scheme is already securely funded.⁹⁵ The same principle applies where an investment in the employer is more likely to result in financial loss than in strengthening the employer.⁹⁶

None the less, trustees who are choosing between equally prudent investment policies may well be justified in opting for that which is most beneficial to the employer. This may well be the one which best accords with the employer's stance

⁹² The Occupational Pension Schemes (Employer Debt) Regulations 2005, SI 2005 No 678. The regulations came into force on 6th April 2005.

⁹³ (1978) 447 F. Supp 1248

⁹⁴ in that case, the purchase of New York City bonds as part of a financial plan to stave off the City's potential bankruptcy

⁹⁵ The circumstances of the scheme in *Cowan v Scargill* were, of course, very different from those in *Withers*; indeed, the Megarry judgment (at page 764) indicated that the *Withers* decision was “soundly based on equitable principles” common to England and most jurisdictions in the United States.

⁹⁶ These points are made in the Pension Regulator's *Guidance to Trustees*, which is on its website. They were previously contained in the “*Guide to Pension Scheme Trustees*” (paragraph 46) issued by the Occupational Pensions Regulatory Authority (“OPRA”) (established by PA 1995 and replaced with effect from 6th April 2005 by the Pensions Regulator). The scope for investment in the employer is now much curtailed by statute (section 40 PA 1995), with employer-related loans in particular being prohibited under the 2005 Investment Regulations (see generally regulations 11 to 16), but that does not affect the principle under discussion here.

on corporate social responsibility (“CSR”). An investment strategy, or particular investment, which ran counter to the employer’s CSR policy might harm the employer’s reputation in the eyes of its shareholders, customers or employees and this could adversely affect the employer’s business. If, however, the employer wished the trustees to avoid certain investments on these grounds and if the trustees were advised that this exclusion would be financially detrimental, they would need to be satisfied that, on balance, it would be in the long-term interests of the scheme for them to comply with the employer’s request.

Trustees are in any event under a statutory obligation to consult the employer before preparing or revising their SIP⁹⁷, and therefore before settling the statements on SEE considerations and on the exercise of shareholder rights which the SIP must contain. (The duty, though, is only to consult; section 35 provides that neither the scheme nor the SIP may impose restrictions (however expressed) on any power to make investment by reference to the consent of the employer.⁹⁸ Further, the 2005 Investment Regulations require that, in the case of a potential conflict of interests, the scheme assets be invested “*in the sole interest of members and beneficiaries.*”⁹⁹

The adoption of an SRI policy might also further a scheme’s purpose of providing financial benefits to eligible employees by encouraging them to become or remain members (or by not deterring them by holding investments which they find unacceptable). Again, where there is a strong corporate culture, an SRI policy which is aligned with the CSR approach of the enterprise is likely to recommend itself to the employees. As general awareness of social responsibility issues increases, the greater may become their role in the promotion of pension schemes to employees.

The discussion in this section has so far related to circumstances in which having regard to SEE considerations may further the provision of financial benefits, albeit in a less direct manner than by increasing investment returns. There remains, however, the question of whether, in framing their investment policy, scheme

⁹⁷ Section 35(5)(b), as originally enacted. Under the new section 35 substituted by section 244 PA 2004, the requirement is contained in regulation 2(2)(b) of the 2005 Investment Regulations.

⁹⁸ Subsection (4) of the original section and subsection (5) of the substituted section.

⁹⁹ Regulation 4(2)(b). This implements a further requirement of Article 18(1)(a) of the Occupational Pensions Directive (see footnote 40). Regulation 4 (11) (in wording similar to that of the Directive (Article 6(f))), defines a “beneficiary” as “a person....entitled to the payment of benefits under the scheme”. Consequently, even if the employer might otherwise have been regarded as a beneficiary (e.g. because of an entitlement to any residual surplus), it cannot be one for this purpose.

trustees should take into account their members' ethical preferences as an end in itself. The Goode Report¹⁰⁰ expressed the view that trustees could do this where there was a choice between investments which were of equal financial merit i.e. provided they were satisfied that there would be no financial disadvantage. This approach was specifically endorsed by the then Pensions Minister (John Denham MP) when first announcing the Government's intention to require disclosure of the trustees' policy on SRI; he described it as the "equitable tie-break"¹⁰¹ The Pensions Regulator's *Guidance for Trustees* takes a similar line:

"It is ...the trustees' duty to act in the best interests of the scheme beneficiaries. As far as investments are concerned this normally means their best financial interests. As far as possible, when you decide on the investment strategy for the scheme, you should put aside your personal views on the ethical aspects of particular investments and get the best financial return that is achievable at the desired level of security or risk.

*However, you can consider non-financial matters when comparing investments with the same potential return. So, you can choose a particular investment which you find more attractive for ethical reasons, as long as the ethical investment is likely to perform as well as, or better than, the non-ethical investment."*¹⁰²

As already mentioned, although the Megarry judgment confirmed that, in a trust for financial benefits, the interests of the beneficiaries will normally mean their financial interests, it also recognised that "benefit" is not always exclusively financial and that where, for instance, all possible beneficiaries had a moral objection to a particular investment, it would be for their benefit if the trustees avoided it, even if that meant a poorer financial return. Because all the possible beneficiaries of a pension scheme cannot be ascertained, the ethical preferences of even all the current beneficiaries could not justify the trustees' adoption of an investment policy which they considered likely to lead to a lower investment return (except on one of the grounds, relating to the provision of financial benefits, referred to above).

If, however, the policy does not involve any financial detriment, there is, it is submitted, no trust law requirement to obtain the views of every beneficiary; if the

¹⁰⁰ See footnote 27.

¹⁰¹ speech to the UK Social Investment Forum, 9th July 1998. A summary of the speech is on the UKSIF website (www.uksif.org).

¹⁰² The predecessor trustee guide issued by OPRA contained identical wording (paragraph 45).

trustees can confer a non-financial benefit on a significant number of their beneficiaries, that should be sufficient justification.¹⁰³

In this context, it is interesting to consider the comments which Sir Robert Megarry made in a lecture in which he revisited the case of *Cowan v Scargill*.¹⁰⁴ Sir Robert pointed out that the NUM-appointed trustees had proposed “a total prohibition on certain types of investment, come what may”. He went on to consider what the outcome of the case might have been if “they had abandoned prohibition and espoused preference” i.e. by adopting an “other things being equal” policy, excluding a particular investment only “if any other investment of equal merit were available”. On the assumption that no beneficiary would suffer any discernible harm, the question would be whether the policy was for the benefit of the beneficiaries generally. Sir Robert commented

“If other things are equal, it may well be contended that an investment in A Ltd. instead of in B Ltd., made because the great majority of the beneficiaries oppose investment in B Ltd. and so gratifying the majority, will neither harm nor benefit the minority, and so will in general be for the benefit the beneficiaries at large. Such a contention seems to have considerable force, though the contrary is not beyond argument.”

Whilst Sir Robert’s comments related to stock selection, a similar principle could be applied to the exercise of shareholder rights in order to promote corporate behaviour which was favoured by beneficiaries on ethical grounds.

As previously noted, a common argument against SRI policies which are based on members’ ethical preferences is that beneficiaries may hold conflicting opinions. Undeniably, there are opposing views on many moral questions, as was recognised in the *Bishop of Oxford’s case*. At the same time, there are many issues on which there is more likely to be a consensus e.g. environmental degradation, human rights’ violations and forced labour in the Third World. Moreover, on some of the most important subjects there are generally-recognised standards, which are often incorporated in international conventions or in codes of conduct. These can provide a non-controversial basis for a scheme’s SRI principles.

Further, the members of a pension scheme may well be more alike in their views on ethical issues than the public at large. This is because they may have been

¹⁰³ For a specific agreement with the original expression of this view in our book, op cit page 98, see page 97 of the Freshfield, Bruckhaus Derringer UNEP FI report referred to in footnote 78.

¹⁰⁴ “Investing pension funds: The Mineworkers case” by Rt. Hon. Sir Robert Megarry in Youden (ed.) “Equity, Fiduciaries and Trusts” (Carswell, Toronto, 1989), pp 149-160.

attracted by, or influenced by, the values of the employer. Thus, whilst the rationale for an ethical preference policy based on conferring a moral benefit on the beneficiaries is distinct from that for a policy based on aligning investment policy with the employer's stance on CSR, the two approaches may well coincide.

Where trustees have regard to ethical preferences in their investment policy, they should be satisfied that the preferences are the beneficiaries', not their own. For a moral benefit to be taken into account properly in the exercise of a fiduciary discretion, it must be one which the beneficiary recognises, not one attributed to him or her by the trustees.¹⁰⁵ Failure to observe this principle would leave the trustees open to the charge that they were in breach of their duty of undivided loyalty to their beneficiaries.¹⁰⁶

Charities

CC14 gives guidance on the three situations¹⁰⁷ identified in *the Bishop of Oxford's case*¹⁰⁸ in which charity trustees can properly allow their investment strategy to be governed by considerations other than the level of investment return:

- (i) where investment in a particular type of business would conflict with the objects of the charity. Thus a charity with objects for the protection of the environment may decide not to invest in businesses which pollute what the charity is trying to protect. CC14 emphasises, however, that this exception applies only to practical conflicts with the charity's aims and activities, not to mere moral disapproval;¹⁰⁹
- (ii) where an investment might hamper the work of the charity, either by making potential beneficiaries unwilling to be helped, because of the source of the charity's money, or by alienating supporters. In such circumstances, trustees must balance these disadvantages against the risk of investment underperformance;¹¹⁰ and

¹⁰⁵ *Re Clore's Settlement Trusts* [1962] 2 All ER 272. See in particular the observations of Pennycuik J at 275.

¹⁰⁶ Accordingly, it is submitted that the Pension Regulator's Guidance on this point, which is quoted above, should not be read as justifying investment decisions based on the personal ethical preferences of the trustees, as distinct from preferences which the trustees know, or at least have reason to believe, to be those of their beneficiaries.

¹⁰⁷ in addition to an express provision in the charity's trust deed

¹⁰⁸ discussed in section 4 above

¹⁰⁹ Paragraph 86

¹¹⁰ Paragraph 89 (N.B. There are no paragraphs numbered 87 or 88.)

- (iii) where a potential investment does not fall within either of the above two categories but the trustees wish to accommodate those who consider the investment inappropriate on moral grounds. The trustees can make such an accommodation provided that they are satisfied that this would not involve a significant risk of financial detriment. CC14 continues:

*“In many cases, trustees may be able to conclude that a particular ethical policy is likely to perform as well as an unrestricted policy. But trustees are not free to use their investment powers to make moral statements at the expense of their charity.”*¹¹¹

CC14 advises trustees to make a judgment in the light of their own circumstances rather than trying to conform to some supposedly homogeneous public opinion and indicates the following six pointers:

- (i) trustees should consider the aims and objectives of the charity;
- (ii) they should keep in mind the fundamental principle of maximising return. Any ethical policy should be set out in writing and be clear on positive aims and any exclusions;
- (iii) the reasons for any exclusion should be clearly thought through. The more the exclusions, the greater may be the risk to returns;
- (iv) the need to evaluate the effect of any proposed policy will usually require expert advice;
- (v) balancing the risk of lower returns against that of alienating support and of damage to reputation cannot be an exact calculation but is “*just one of many areas where trustees have to identify and manage risk*”; and
- (vi) trustees are unlikely to be criticised for adopting a particular policy if they have considered the correct issues, taken appropriate advice and reached a rational result.¹¹²

There are evidently some analogies between the grounds, other than investment return, on which charity trustees can take SEE considerations into account and those to which pension scheme trustees may have regard, e.g.:

¹¹¹ Paragraph 90

¹¹² Paragraph 91

- (i) an investment policy which would be damaging to the reputation of the employer might conflict with the object of the scheme, the provision of financial benefits, where securing that object depends upon the employer's continuing in business;
- (ii) an investment policy of which actual or potential members of the scheme disapproved might hamper the purposes of the scheme by discouraging employees from becoming or remaining members; and
- (iii) trustees may adopt an investment policy which accommodates the ethical preferences of beneficiaries provided this does not jeopardise financial returns.

Clearly, these are not exact equivalents and it remains true that, generally, charities have a greater scope than pension schemes for engaging in SRI or ethical investment based on criteria other than investment return. None the less, the similarities are perhaps greater than might be initially supposed, given the different natures of the trusts concerned.

For completeness, it should be noted that CC14 draws a distinction between, on the one hand, ethical investment or SRI and, on the other hand, programme-related investment ("*PRI*") or social investment.¹¹³ Indeed, *PRI* is not regarded as "*investment*" at all for the purposes of CC14, as it is a method of carrying out the objects of a charity, even though the way in which this is done may resemble "*investment*" by the charity.¹¹⁴ The purchase of small holdings of shares in particular companies so as to participate in general meetings and thereby influence the way in which the company conducts its business is considered a form of *PRI*, if this advocacy is within the objects of the charity.¹¹⁵ The Charity Commissioners have issued separate guidance on this subject.¹¹⁶ There is nothing in a pensions context which corresponds to *PRI*.

6. Charity Pension Schemes

In principle, the trustees of a pension scheme for the employees of a charity have the same fiduciary duties as the trustees of any other scheme. Those duties include

¹¹³ Paragraph 81

¹¹⁴ Paragraph 13

¹¹⁵ Paragraph 14

¹¹⁶ "*Charities and Social Investment*" (4th October 2004)

the general obligation to invest with a view to achieving the best balance of risk and return. None the less, trustees of charity pension schemes are especially likely to have to give weight to the other considerations discussed in the previous section.

Firstly, the risk that inappropriate investments might be damaging to the reputation of the employer may be particularly acute. The Charity Commissioners in their 1991 Annual Report advised charity trustees to take care when considering whether to enter into arrangements with commercial third parties under which the charity's name would be used. They commented that:

"The charity's name is a valuable asset."

The public will probably perceive the link between a charity and its pension fund to be even closer; they are unlikely to be impressed by technical distinctions between the charity and the scheme, however legally correct these might be.

A good example of this was the bad publicity that The British Heart Foundation suffered in 1998 when it was discovered that its employees' pension fund had been investing in the tobacco industry.¹¹⁷ This was particularly embarrassing for a charity which campaigns against smoking and has a strict policy not to make such investments itself.

Indeed, any inconsistency between the investment policy a charity and that of its pension scheme is likely to be more readily apparent than an equivalent mismatch in the case of a commercial enterprise. This will be particularly so where a detailed comparison can be made of the specific provisions of the respective governing instruments and SIPs of the charity and of the scheme; the very similarities in structure and regulation will bring any discrepancies into sharper focus.

Secondly, the employees of a charity might be expected to share a heightened awareness of social and ethical issues, not only in relation to the charity's particular sphere of activity but also more generally. They are therefore more likely to wish to see these concerns reflected in the way in which their retirement funds are invested.¹¹⁸

As already indicated, there are different ways in which trustees can take SEE considerations into account in the investment of scheme assets. They (or their fund

¹¹⁷ referred to in our book, op cit at page 68

¹¹⁸ This was one of the points made in the responses received in the survey of consultant actuaries to pension schemes which was carried out for our book and which is contained in Appendix 1 to our book op cit.

managers) can incorporate such considerations into the overall strategy for a collective portfolio, whether in respect of stock selection or engagement policies. Alternatively, they can give scheme members the opportunity to invest in a range of investment funds (typically managed by insurance companies as external providers) which include one or more socially responsible or ethical options.

An interesting example of how the above factors can influence the investment structure of charity pension schemes was afforded in the course of some research carried out for our book. This involved an update of the survey of fourteen large pension schemes which was conducted in 2002 by Just Pensions.¹¹⁹ All but one of the funds in question were either private sector or local authority schemes. The exception was The Pensions Trust, which is one of the leading providers of pensions for employees and former employees of charitable, social, educational, voluntary and not-for-profit organisations.

The Pensions Trust acts as corporate trustee to thirty-eight separate schemes and at the time of the update was in the course of agreeing a specific investment strategy for each scheme. The Trust offered various investment options. One option was the Legal & General FTSE4Good SRI Balanced Index Fund, the equity component of which tracks the UK and Global FTSE4Good indices. This was used by two of the Trust's defined benefit schemes. Another ethical option was the F & C Stewardship Managed Fund, which was available for additional voluntary contributions but also as a main investment option for defined contribution schemes.

Further information in this regard is available on The Pension Trust's website.¹²⁰ This shows, for example, that one of the ways in which the Trust addresses the question of the suitability of ethical investment options¹²¹ is to warn members who may be considering choosing the Stewardship Fund that its policy of negative screening is likely to make its investment performance more volatile and that this makes it less appropriate for members who are closer to retirement.

The prospect that the trustees of charity pension schemes will be under greater pressure to make the scheme's investment policy consistent with the objects of the charity and with the ethical views of the members raises the question of whether the trustees may be especially exposed to potential conflicts of interest.

¹¹⁹ "Do UK Pension Funds Invest Responsibly?" The original survey is on the UKSIF website (www.uksif.org). The update (together with a copy of the survey) is in Appendix 2 to our book *op cit*.

¹²⁰ (www.thepensionstrust.org.uk).

¹²¹ See section 3.4.

Both the original Just Pensions survey and the update in our book discovered differing opinions between two of the schemes surveyed on the issue of how far, if at all, the investment policy of a scheme should be aligned with the employer's stance on CSR.¹²² The more negative view was that this posed a threat to pension scheme independence.

As stated in the survey update in our book, it is submitted that in order to avoid any such conflict it is important that the different perspectives of the employer and its pension scheme be recognised. For the employer, its scheme is a part of its overall operations; for the scheme trustees, the interests of their beneficiaries are paramount. Those interests may well be best served by SRI policies or investment options which are calculated to increase investment returns, to protect the good name of the employer or to give effect to the ethical concerns of their beneficiaries (which may often be consonant with the values of the employer). If that is so, such policies and options should recommend themselves to a trustee board which is wholly independent of the employer. Trustee independence and a common enlightened approach to SRI may therefore be seen as complementary, not conflicting, hallmarks of good pension scheme governance.

As already suggested, the general principles outlined in the previous paragraph are likely to have particular force in the case of charity pension schemes. There may, moreover, be a more specific consideration which could especially help charity schemes to avoid conflicts of interest in relation to SRI or ethical investment. In the lecture referred to in section 5.2 above¹²³, Sir Robert Megarry observed that investment questions of the kind raised in *Cowan v Scargill* could be resolved by express provisions in the scheme's trust deed; these might be inserted either in the initial drafting or by using the scheme's power of amendment.¹²⁴ Sir Robert suggested that, for example, the power of investment might be framed so as to exclude certain types of investment or so as to require the trustees to give effect to the wishes of a majority of the beneficiaries.

Currently, one potential statutory impediment to such an approach is the requirement under section 590 of the Income and Corporation Taxes Act 1988 (ICTA) that, in order to qualify for Revenue approval, pension schemes must be established for the "*sole purpose*" of providing "*relevant benefits*" (the definition

¹²² The schemes in question are both in the private sector.

¹²³ See footnote 104.

¹²⁴ This developed an aside in the judgment: [1984] 2 All E R at 766. Some possible difficulties where the exercise of a power of amendment is required are discussed in our book *op cit* at section 4.3.7.

of which is financial in nature).¹²⁵ This condition, however, has not been carried over to the new tax regime for pension schemes under Part 4 of the Finance Act 2004, which will come into force on 6th April 2006.¹²⁶

Whilst the option of incorporating specific wording on SRI in its pension scheme's trust deed is open to any sponsoring employer, it could be particularly attractive for a charity, especially one which has similar provisions in its own governing instrument. In this way, a consistency of approach between charity and pension scheme could be formally documented.

¹²⁵ although, under section 591 ICTA, the Revenue has a discretion to waive prescribed conditions for approval.

¹²⁶ Neither the definition of "*pension scheme*" in section 150 of the Act nor the requirements in sections 153 to 155 for becoming a "*registered pension scheme*" (and thus enjoying tax reliefs and exemptions under Chapter 4 of Part 4 of the Act) contain anything corresponding to the "*sole purpose*" rule.