Pension Fund Trustees and Fiduciary Duties: Decision-making in the context of Sustainability and the subject of Climate Change

6 February 2024
<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brian Gray</td>
<td>Chief Executive</td>
</tr>
<tr>
<td>Becky Jacombs</td>
<td>Senior Researcher</td>
</tr>
<tr>
<td>Sir Robin Knowles CBE (Chair)</td>
<td>Durham University</td>
</tr>
<tr>
<td>Professor Philip Bennett</td>
<td>Durham University</td>
</tr>
<tr>
<td>Sir William Blair</td>
<td>Queen Mary University of London</td>
</tr>
<tr>
<td>Victoria Brock</td>
<td>His Majesty’s Treasury (Observer)</td>
</tr>
<tr>
<td>Laura Burgoyne</td>
<td>The Law Commission (Observer)</td>
</tr>
<tr>
<td>Simran Chard</td>
<td>Royal Courts of Justice</td>
</tr>
<tr>
<td>Kate Gibbons</td>
<td>Clifford Chance LLP</td>
</tr>
<tr>
<td>Mark Hill</td>
<td>The Pensions Regulator / The Stewardship Regulators Group (Observer)</td>
</tr>
<tr>
<td>Bella Landymore</td>
<td>Impact Investing Institute</td>
</tr>
<tr>
<td>Paul Lee</td>
<td>Redington</td>
</tr>
<tr>
<td>Ida Levine</td>
<td>Two Rivers Associates Limited</td>
</tr>
<tr>
<td>Andrew Lewis</td>
<td>Travers Smith LLP</td>
</tr>
<tr>
<td>Professor Colin Mayer CBE</td>
<td>British Academy</td>
</tr>
<tr>
<td>Maria Nazarova-Doyle</td>
<td></td>
</tr>
<tr>
<td>Luba Nikulina</td>
<td>IFM Investors</td>
</tr>
<tr>
<td>Stuart O’Brien</td>
<td>Sackers &amp; Partners LLP</td>
</tr>
<tr>
<td>David Pollard</td>
<td>Wilberforce Chambers</td>
</tr>
<tr>
<td>Olivia Prentice</td>
<td>Bridges Fund Management</td>
</tr>
<tr>
<td>Eliette Riera</td>
<td>Principle for Responsible Investment</td>
</tr>
<tr>
<td>Mark Rogers</td>
<td>Department for Work and Pensions (Observer)</td>
</tr>
<tr>
<td>David Rouch</td>
<td>Freshfields Bruckhaus Deringer LLP</td>
</tr>
<tr>
<td>Paul Todd</td>
<td>Nest Pensions</td>
</tr>
<tr>
<td>Roger Urwin</td>
<td>Willis Towers Watson</td>
</tr>
</tbody>
</table>

*Please note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only*
Index

1. This Paper 1
2. Duties and “fiduciary duties” 2
3. Investment of the pension fund: decision-making responsibility 3
4. “Financial” and “non-financial” factors 4
5. Sustainability 6
6. Climate change 6
7. Taking decisions as pension fund trustees with fiduciary duties 9
8. “Numbers and narrative” 11
9. Portfolios, and investing in pooled or passive funds 11
10. Stewardship after the decision to invest 12
11. The time ahead 13
About the FMLC

The role of the Financial Markets Law Committee (the “FMLC” or the “Committee”) is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1. This Paper

1.1 For pension funds, setting investment strategy, principles and policies and making investment decisions have all become more challenging in the context of sustainability and the subject of climate change.

1.2 This has given rise to renewed uncertainty over what the “fiduciary duties” or trust duties owed by trustees of pension funds require in this context.\(^1\) Today it is sometimes easier to state the duties than it is to apply them.

1.3 The issue is a legal issue. It sits in the context of legislation and regulation that applies to pension funds, pension schemes and pension fund trustees\(^2\), but relevantly it also engages other areas of law.

1.4 This paper is intended to provide, in terms that are understandable to pension fund trustees, a very general explanation of the legal position and the uncertainties and difficulties that exist. It is hoped this may help trustees in their discussions with their advisers. It is not advice and should not be relied on as advice. The footnotes offer some additional commentary, and allow ease of reference by advisers. Rather than a longer and comprehensive report, we have endeavoured to produce a short paper that trustees can have with them in the meeting room or as they read the papers before a meeting.\(^3\)

1.5 Since the pensions sector is a major allocator of capital, legal uncertainties affecting pension fund trustees have the potential to adversely affect the wholesale financial markets. In keeping with our general remit, FMLC has sought only to address legal uncertainties which may impact what decisions and actions are permissible for trustees. This paper should not be taken as encouraging pension fund trustees in any policy direction in relation to questions of sustainability and the subject of climate change.

1.6 Sustainability and the subject of climate change are of importance to pension funds generally, and beyond that to economies as a whole, and to the population at large. These are subjects that make particular demands in the consideration of risk and return over time.

---

1 Recent references to this uncertainty appear to have been shown in responses to the Government’s call for evidence launched 11 July 2023 entitled “Pension trustee skills, capability and culture”: see paragraph 72 of the Government’s response to that call for evidence published 22 November 2023 https://www.gov.uk/government/calls-for-evidence/pension-trustee-skills-capability-and-culture-a-call-for-evidence/outcome/government-response-to-pension-trustee-skills-capability-and-culture-a-call-for-evidence.

2 Including, where applicable, wider financial services legislation and regulation.

3 In 2014 and 2017 the Law Commission of England & Wales examined the subject of fiduciary duties in two valuable and thoughtful reports: “Fiduciary Duties of Investment Intermediaries” (Law Com No 350) 30 June 2014; “Pension Funds and Social Investment” (Law Com No 374) 22 June 2017. We draw on these reports at various points, but experience since the reports were published allows the opportunity to look further at some of the points made in them. We acknowledge with admiration and respect the great deal of thought, discussion and writing that has followed those reports.
1.7 This paper is for pension fund trustees, but for that reason it is also relevant to advisers (including legal advisers and investment consultants) and investment or fund managers, beneficiaries and employers, insurers and investees. The paper addresses specifically pension schemes established as trusts, but the approach is relevant to other schemes including contract-based schemes, and local authority schemes. The subject of climate change is addressed specifically, but the approach is relevant to other areas of sustainability.

1.8 The FMLC is an independent body that seeks to reduce legal uncertainty in the financial markets. Where legal uncertainty over the “fiduciary duties” or trust duties owed by trustees of pension funds can be reduced it is important that, where possible, efforts are concentrated to that end. The public interest in these efforts is heightened in the context of sustainability and the subject of climate change.

1.9 In order to help produce this paper the FMLC has drawn on a wide range of different relevant expertise and experience, legal and non-legal.

2. Duties and “fiduciary duties”

2.1 “Fiduciary” duties or “trust” duties are among the legal duties owed by pension fund trustees.

2.2 The starting point is the purpose of the trust. At centre, this will be to use the assets of the trust (the pension fund) to pay pensions over time to beneficiaries of the trust.

---

4 An employer may be the settlor (and determine investment options written into a trust deed), a provider of contributions, a funder of last resort, and have an interest in surplus funds. In these circumstances, among others, the employer may have a close interest in the matters discussed in this paper.

5 For example, in contract-based rather than trust-based schemes many of the considerations addressed in this paper will be relevant to providers and to independent governance committees. As always advice should be sought.

6 Different arrangements for pension schemes attract different regulatory regimes and this paper does not disturb that position.

7 The paper is focused on the law of England & Wales.

8 The language respects the points that views can differ over whether or not particular duties are best termed “fiduciary”, and that some fiduciary duties may sit alongside duties are not fiduciary in nature but are nonetheless duties of pension fund trustees in connection with setting investment strategy and making investment decisions. The terms of the trust deed or equivalent may specify other powers and duties of the trustee and provide restrictions or limitations on those powers and duties. Of course these too must be respected.

9 The terms of the pension trust deed or equivalent may (expressly or impliedly) set out the purpose of the trust. The Law Commission expressed the view that pension schemes that are established by contract rather than trust “should, as far as possible, be subject to equivalent provisions and result in the same outcomes for pension savers”: Law Com No 374 para 1.30. Views differ on whether this is achieved today, but many of the considerations addressed in this paper will be relevant to schemes established by contract as well as schemes established by trust.

10 Where it is proposed to transfer the liabilities of a defined benefit pension scheme to an insurance company considerations discussed in this paper may still be relevant because the focus is still on delivery of the benefits the scheme was established to provide.

11 Of course different schemes may be in different positions and the differences may be material. For example the scheme may provide defined benefit or money purchase benefits, may be closed or open, and the age profile of beneficiaries may be different. Sometimes there will be a residuary interest, such as, in respect of a defined benefit scheme, that of an employer to whom surplus scheme assets may be returned if certain conditions are met. An employer, in a defined benefit scheme, is the funder of last resort under Part 3 of the Pensions Act 2004 and Section 75 of the Pensions Act 1995 unless an exception under that legislation applies.
2.3 Overall responsibility for a pension scheme rests with pension fund trustees. A pension fund trustee is a “fiduciary” because they are “someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence”. Fiduciary duties are “imposed by law as a reaction to particular circumstances of responsibility assumed by one person in respect of the conduct of the affairs of another”. The duties of the trustee also include a duty of care when investing, and although not itself a “fiduciary” duty this duty is part of the context for the “fiduciary” duties.

2.4 Pension fund trustees have a duty to “promote” (achieve) the purpose of the trust and to use their powers properly and lawfully in order to do that. They act in the interests (under the scheme’s trust) of the beneficiaries.

2.5 Pension fund trustees are required to put the scheme and the interests of the beneficiaries first, to the exclusion of their own interests.

2.6 “The distinguishing obligation of a fiduciary is the obligation of loyalty.” Thus, as they make decisions in the conduct of the affairs of the scheme, pension fund trustees are required to put the scheme and the interests of the beneficiaries first, including consideration of stages along that term.

2.7 The scheme and the beneficiaries count on the pension fund trustees to give due consideration to relevant matters in setting strategy, principles and policies and taking decisions concerned with investment. On the whole, the duties of pension fund trustees support them in taking a broad perspective and a long-term outlook.

2.8 Pension fund trustees are, broadly speaking, not judged in hindsight nor are they expected to have perfect foresight when making complex decisions about investment. The presence of fiduciary duties does not require undue caution. In fact, too little or too much caution is not in line with responsibility “for the conduct of the affairs of another” where those affairs are financial.

3. **Investment of the pension fund: decision-making responsibility**

3.1 Pension fund trustees will have expert advisers and expert fund or investment managers will be involved. Pension fund trustees should challenge these professionals to help the trustees to meet their obligations.

---

12 The pension fund trustee may be a company. The company will have directors and those directors will owe to the company the fiduciary duties that company directors owe. However the focus of this paper is on the fiduciary duties of the pension fund trustee or trustees, individual or corporate, that are owed to the scheme and its beneficiaries.


14 F&C Alternative Investments (Holdings) Ltd v Barthelemy (No 2) [2011] EWHC 1731 (Ch); [2012] Ch 613 at [215] (Sales J), recently cited with approval by the Court of Appeal in Tulip Trading Ltd (a Seychelles company) v Bitcoin Association for BSV and Others [2023] EWCA Civ 83 at [48]. Fiduciary duties may differ between different forms of fiduciary relationship (see for example Professor Dame Sarah Worthington “Fiduciaries then and now” [2021] 80 CLJ 154). Fiduciary duties may be modified in the particular context by, for example, the terms of the trust deed.

15 At least on some analyses: see footnote 8 above.

16 Bristol and West Building Society v Mothew [1998] Ch 1, 18 A-C (Millett LJ), cited with approval in the Supreme Court as above.

17 Some investment managers may be described as professional advisers or fiduciary managers, but the focus in this paper is on the function fulfilled.
3.2 Advisers will advise. They will be the first to point out that it is not their role to make the decisions that need to be made. Their advice will often be followed, but if their advice is simply “rubber-stamped” by the pension fund trustees then the trustees are abrogating decision-making responsibility that is theirs and not that of the advisers. That is not what the law requires.

3.3 It is important that the advisers make clear, and pension fund trustees understand, (a) what the advice is based on and (b) what the advice covers and what it does not. Even if advisers have properly taken a relevant matter into account for their advice, it is still for the pension fund trustees themselves to take that relevant matter (and the advice) into account for their decision. There may be other relevant matters which the advisers have not taken into account; it is for the pension fund trustees to make sure those relevant matters are taken into account. The potential for AI to have growing significance in advice provision perhaps reinforces the importance of pension fund trustees having ultimate responsibility for decisions.

3.4 Pension fund trustees generally delegate day to day investment management decisions to investment managers that the trustees have appointed and from whom they will receive reports. Investment managers are appointed typically to provide their services within a set of commercially agreed guidelines that reflect the strategy, principles and policies that the pension fund trustees will have decided after taking advice and after any required or appropriate consultation. It is well understood that pension fund trustees must take reasonable care in the selection of an investment manager and in monitoring the work of the investment manager.

3.5 In order to identify and consider relevant matters properly, it is important for pension fund trustees to ensure that they and the advisers and the investment managers do not work in “silos”. Open dialogue within and between pension fund trustees and advisers and investment managers is essential for ensuring balanced advice and decision-making that does not miss critical context.

4. “Financial” and “non-financial” factors

4.1 In an examination of the subject of fiduciary duties in the context of pension fund investment, the Law Commission of England & Wales offered what it described as “the key distinction” between “financial” and “non-financial” factors.

4.2 The Law Commission first identified the pension fund trustees’ primary investment duty as “balancing returns against risks”.

---

18 These may affect the context of the advice but most importantly they may affect the decision that the pension fund trustees have to make.

19 See in particular PERG 10.3 Qs7-9: FCA Perimeter Guidance OPS

20 The commercially agreed guidelines are suitably recorded contractually in or pursuant to an investment management agreement or similar document. A practical approach will be required where terms available from managers are standardised rather than bespoke.

21 In some circumstances, apart from any legal advice taken or to be taken by pension fund trustees, it may be relevant to consider where and what legal advice has been taken by investment managers or by advisers who are not legal advisers.

22 See footnote 3 above. The Law Commission’s reports do not have the force of law but offer a significant contribution to understanding of the law of England & Wales and to the question of law reform.

23 Paragraph 1.13 of Appendix 1 to Law Com No 374.

24 Paragraph 1.13 of Appendix 1 to Law Com No 374.
4.3 It then defined “financial factors” (or “financially material” factors\(^25\)). It defined these as “any factors which are relevant to pension fund trustees’ primary investment duty of balancing returns against risks”.\(^26\)

4.4 The Law Commission went on to refer to “non-financial factors”. It described these as “... factors which might influence investment decisions that are motivated by other (non-financial) concerns, such as improving members’ quality of life or showing disapproval of certain industries”.\(^27\) The Law Commission said: “In general, non-financial factors may be taken into account if two tests are met: (1) trustees should have good reason to think that scheme members would share the concern; and (2) the decision should not involve a risk of significant financial detriment to the fund.”\(^28\)\(^29\)

4.5 However, not all legal opinion has agreed with the Law Commission’s analysis when it came to “non-financial” factors.\(^30\)

4.6 It is important to have in mind two things when considering the Law Commission’s analysis. First, that what distinguishes a “financial factor” from a “non-financial factor” is the motive underlying its consideration rather than the nature of the factor.

4.7 The second thing to have in mind is how broad “financial factors” are today. Many factors that may appear at first to be “non-financial factors” are “financial” when properly understood. On any view “financial factors” should be taken into account.\(^31\)

---

\(^{25}\) Paragraph 5.100 of Law Com No 350.

\(^{26}\) Paragraph 1.13 of Appendix 1 to Law Com No 374, and see paragraph 6.24 of Law Com No 350.

\(^{27}\) Paragraph 1.13 and 1.23 of Appendix 1 to Law Com No 374 summarising Law Com No 350 and especially Chapter 6. At paragraph 5.50 of Law Com No 374 the Law Commission also said that “trustees cannot simply refuse to take account of non-financial factors in all circumstances, however serious the potential harm to scheme members”. This is not inconsistent with the focus being on the scheme, its purpose and beneficiaries. One of the areas where advice will be essential will be where the future profile of beneficiaries is complex.

\(^{28}\) Paragraph 1.25 of Appendix 1 to Law Com No 374 summarising Law Com No 350 and especially Chapter 6.

\(^{29}\) In \textit{R (on the application of Palestine Solidarity Campaign Ltd and another) v Secretary of State for Housing, Communities and Local Government} [2020] UKSC 16 at [43] Lord Carnwath said of Law Com No 350: “That report in turn may be seen as having settled a long-running debate as to the extent to which pension trustees could take account of non-financial factors, dating back to cases such as \textit{Cowan v Scargill} [1985] Ch 270 (see for example Lord Nicholls \textit{Trustees and their Broader Community: where Duty, Morality and Ethics Converge} (1996) Australian Law Journal Vol 70, p 206). There appears now to be general acceptance that the criteria proposed by the Law Commission are lawful and appropriate. I agree.” See also Lord Wilson and Lady Hale at [17].

\(^{30}\) Most notably, the Association of Pension Lawyers Investment & DC Sub-Committee in its note “Trustees taking into account non-financial factors when making investment decisions” (June 2020).

\(^{31}\) Note that the Occupational Pension Schemes (Investment) Regulations 2005 at Regulation 2(4) as amended on 1 October 2019 by The Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) ( Amendment and Modification) Regulations 2018 (S.I. 2018/988), provide that “financially material considerations” include (but are not limited to) environmental, social and governance considerations (including but not limited to climate change), which the trustees of the scheme consider financially material. In 2017, statutory guidance was published to assist administering authorities in the local government pension scheme in England and Wales with the formulation, publication and maintenance of their Investment Strategy Statement required by Regulation 7 of The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016. The guidance contemplated the use of the Law Commission’s “non-financial factors” test, but perhaps more materially included the following:

“The law is generally clear that schemes should consider any factors that are financially material to the performance of their investments, including social, environmental and corporate governance factors, and over the long term, dependent on the time horizon over which their liabilities arise.”
5. **Sustainability**

5.1 There are various definitions of the term “sustainability”. This paper concentrates on the area of sustainability concerning climate change. Whatever the preferred definition, sustainability is integral to decision-making by pension fund trustees where it may affect financial return or risk.

5.2 Matters “relevant to trustees’ primary investment duty of balancing returns against risks” are, in the Law Commission’s terminology, “financial factors”. The Law Commission gave a particular emphasis to long-term sustainability.\(^{32}\)

5.3 How the particular circumstances weigh in the pension fund trustees’ decision-making will depend on the due consideration of relevant matters in the particular case, with the benefit of advice. The pension fund as a whole and the economic and financial systems in which the fund exists will be among the areas for consideration in most instances of balancing risk and return.

5.4 These points are not radical. They recognise, in the context, that return must be considered with the associated risks, and both return and risks may change, develop or become differently understood and evaluated over time.

5.5 Sustainability may reduce risk or improve return. Taking sustainability into consideration may reveal new understandings of unrewarded or unmanaged risks or illuminate true return.

5.6 Within that framework, sustainability is therefore for consideration in all pension schemes. The relevant entry point for consideration of sustainability in the context of pension funds is as a financial factor rather than as a non-financial factor.

5.7 The risk and return under consideration includes the return on a particular investment or from adopting a particular policy and the risk to that return. But in the context of a pension fund and the purpose of a scheme, also relevant to a decision is the effect of the decision on return or risk anywhere across the pension fund and its various relevant time horizons.

6. **Climate change**

6.1 Climate change is properly seen as an important area of sustainability with an impact that changes over time.

6.2 Pension fund trustees do not need to become expert themselves in the science of climate change. But on any view the responses of governments, businesses, consumers and the public to the subject of climate change (including the actual or perceived threat of failure from climate change) are relevant. These may drive changes in behaviour and conduct, law and regulation, economies and finance, confidence and reputation\(^{33}\) which go directly to due consideration of financial risk and return.

6.3 Can pension fund trustees leave the relevance of the subject of climate change to what is required by current legislation and regulation? The answer is straightforwardly “no”, because that approach would not address all the risk. Of course current legislation and regulation are of great importance, although they are not the only sources of law that are relevant.\(^{34}\) But, as noted, the subject of

\(^{32}\) Law Com No 350 paragraphs 6.25-6.26.

\(^{33}\) Including loss of “social licence”.

\(^{34}\) Common law, the law of equity, law derived from constitutions, and customary and traditional law, are all among the sources of law treated as relevant in different parts of the world in the context of the subject of climate change.
climate change affects the consideration of risk and return from changes or potential changes in behaviour and conduct, economies and finance, confidence and reputation quite apart from changes through law and regulation. As for legislation and regulation, in some countries the subject of climate change will be addressed in legislation or regulation, in other countries it will not. Where it is addressed, the treatment may not be complete. And the national and international picture in terms of legislation and regulation will likely not stand still.

6.4 It may not be difficult to accept that the overall direction of change over time will be away from activity that could have adverse climate change consequences, although even then there will be differences. But important too is the point that material developments may sometimes be sudden, or without alignment to existing investment strategies, or with retrospective effect, or may reverse previous developments, or occur without exit routes.

6.5 One thing (among others) that is increasing is dispute or litigation risk in connection with businesses’ and governments’ response (or lack of response) to the subject of climate change. Because the subject of climate change is a worldwide issue, this is a risk that can present from anywhere in the world. It brings its own relevant issues, including possible adverse outcome and responses, but also the cost, the time and the element of uncertainty in litigation or arbitration. If it is a risk that comes with an investment it may outlast the holding of an investment.

6.6 Pension funds exist as participants in much wider financial and economic networks. It is a feature of the subject of climate change that it is of major scale. From the position of the pension fund trustee, all the changes identified above or the possibility of them may be relevant to the return of a particular investment and the risk to that return. But so too certain investment strategies, principles and policies may be particularly vulnerable to their impact. And, as with sustainability generally, in the context of a pension fund and the purpose of a pension scheme, relevant too is the effect of the subject of climate change on return or risk anywhere across the pension fund and including by reference to all applicable time horizons. Financial factors therefore need to be considered at a number of levels: at the level of a specific asset or investment, at a portfolio level, and at the level of whole economies material to the pension fund.

6.7 It is possible to view the subject of climate change as something that has made the area of pension fund investment more complex than even a decade ago. But on further consideration it is possible to begin to see the area as capable of being less complex, at least given time, as understanding of the relevant risks and true returns improves. Sustainability and the subject of climate change may in fact develop or deepen further our appreciation of what represents return and risk. They may help us understand further the importance of time horizons. Changes in return over time and systemic risk are among the matters that have to be understood well. Throughout, rigour of analysis and consideration is important.

35 Even if rights protecting investments may mitigate the effect of some retrospectively effective changes, the analysis will need to include, among other things, questions of cost, time and uncertainty in the enforcement of those rights.

36 See the litigation monitoring work undertaken by the Grantham Research Institute on Climate Change and the Environment (LSE); the Sabin Center for Climate Change and the Law (Columbia Law School) and the Centre for Climate Change Economics and Policy (LSE and University of Leeds). (https://www.lse.ac.uk/granthaminstitute/wp-content/uploads/2023/06/Global_trends_in_climate_change_litigation_2023_snapshot.pdf.)

37 Some aspects of sustainability present systemic risk but some may not.

38 We understand that advisors increasingly make use of concepts such as double materiality and dynamic materiality, real world impact, “universal owner” risk, theories of change, and seeing pension funds and their
6.8 The consideration necessary involves new or particular dimensions. As examples only:

I  What might previously have been regarded as non-financial returns or risks may now need to be recognised as financial returns or risks or as relevant to financial returns or risks.

II An investment decision may properly be viewed in the context of a wider strategy aimed at tackling a sustainability risk to financial performance of all or part of the pension fund.\(^{39}\)

III It may be necessary to consider whether a strategy should reject shorter term gains because they create identifiable risks to the longer term sustainability of investment returns in the fund.

IV Whereas some wider economic or systemic climate change-related issues may have been characterised as "too remote and insubstantial" in the past,\(^{40}\) pension fund trustees will need to reappraise this in a context where, for example, physical, transition and litigation risks are now apparent and material.

V With climate-change related risks that are systemic, it is unlikely that diversification alone of a portfolio will be enough to avoid all the risks in the same way that non-systemic risks might be diversified away from.

6.9 The risks include transition risk as the global economy attempts to move towards a lower emission future. Transition risk includes the likely effects of economic and social displacements. At the same time transition is likely to require investment in new jobs, re-skilling and infrastructure, including to address disproportionate impact on certain groups of people and places. Thus, transition of the global economy in response to climate change considerations could also generate sources of investment return.

6.10 The risks and uncertainty for pension fund trustees may be less if an investment strategy looks for investees who approach, or would as a result of investment approach, sustainability and the subject of climate change in a manner that supported the approach of the pension fund.

6.11 Some investments will be marketed or offered as designed to be positive in their "impact" on sustainability and climate change. Some of these may involve a reduction in financial return to reflect the use to which the investee will put the sums invested in the interests of sustainability or to address the subject of climate change. In principle, these investments may still properly be considered by pension fund trustees in keeping with their duties (and by their investment managers); they do not fall outside what may be considered. But both financial return and risk would be the considerations, and at the level of the investment, at a portfolio level, and at the level of whole economies material to the pension fund.

---

\(^{39}\) This may lead to a different result as compared with an isolated assessment of an investment proposition only taking account of the particular sustainability risks to which the investment or investee is exposed.

\(^{40}\) Paragraph 6.53 of Law Com No 350.
None of the above is to confuse the purpose of a pension scheme with that of a charity, environmental or otherwise. Nor is it to suggest that the duties of pension fund trustees require investments involving (say) fossil fuel extraction associated with high emissions to be declined. But nor is it to require an approach that is other than careful and measured.

7. Taking decisions as pension fund trustees with fiduciary duties

7.1 In the context under discussion, how in practice can pension fund trustees better succeed in taking decisions in keeping with their fiduciary duties?

7.2 The law requires pension fund trustees to reach a careful decision. It requires that they take into account all relevant matters, and not take into account irrelevant matters. But provided they approach a decision properly, and for a proper purpose, acting within their powers, and give due consideration, and do not neglect to make decisions when they should, pension fund trustees should not fear liability. The law recognises that at times there may be a range of appropriate decisions, and that sometimes (for example) a decision for an investment may be just as appropriate as a decision against.

7.3 Nonetheless it is a significant task to identify and take into account all relevant matters. It will be assisted by advisers and investment managers. The points below may assist in the context of sustainability and the subject of climate change.

I In constructing strategy, principles and policies, and throughout the management of the fund, it is proper for pension fund trustees to situate their pension fund within the wider economy. In doing so, sustainability and the subject of climate change, can, along with other factors, be considered by pension fund trustees when seeking to achieve the purpose of the scheme.

II The pension fund trustees enjoy an advantage from the fact that they will not generally be involved in directing specific day-to-day investment decisions; they can stand back and see the wider picture and the time horizons, and questions such as resilience. Sustainability and the subject of climate change may call for decisions over and above decisions on whether or not to make a particular investment.

III Pension fund trustees may need to consider further what they require from advisers or investment managers, in order to do their job as trustees. Can pension fund trustees describe their thinking in terms of balancing risk and returns, their appetite for risk and why? Are pension fund trustees and advisers (and, in turn, investment managers) fully

41 In Futter & Anor; Holt & Anor v HMRC [2013] UKSC 26; [2013] 2 AC 108 at [73] (Supreme Court), Lord Walker said:

“In my view Lightman J was right to hold that for the rule to apply the inadequate deliberation on the part of the trustees must be sufficiently serious as to amount to a breach of fiduciary duty. Breach of duty is essential (in the full sense of that word) because it is only a breach of duty on the part of the trustees that entitles the court to intervene (apart from the special case of powers of maintenance of minor beneficiaries, where the court was in the past more interventionist: see para 64 above). It is not enough to show that the trustees’ deliberations have fallen short of the highest possible standards, or that the court would, on a surrender of discretion by the trustees, have acted in a different way. Apart from exceptional circumstances (such as an impasse reached by honest and reasonable trustees) only breach of fiduciary duty justifies judicial intervention.”

42 Legislation and regulation already applying to some schemes is consistent with this: see in particular section 41A-41C Pensions Act 1995 and the Occupational Pension Schemes (Climate Governance and Reporting) Regulations 2021.
aligned on strategy, principles and policies, including how issues of sustainability and the subject of climate change have been considered and assessed?

IV Understanding of investments and markets is continually developing and it is proper for pension fund trustees to seek out contemporary thinking, looking to their advisers and investment managers for this. This includes taking account of what investment analysts can contribute in relation to sustainability and the subject of climate change but also potential shortfalls or gaps in that contribution. At any point in time, markets and asset prices may not themselves reflect the full risk and return where sustainability and the subject of climate change are concerned.

V Pension fund trustees can properly take steps to guard against the risk of focussing so much on one matter they fail to give due consideration to other relevant matters. The weight to be given to different matters is an important part of the process of reaching a decision in the circumstances of the case. Given the potential significance to financial risk and return, it would be very difficult to accept that pension fund trustees, advisers or investment managers might responsibly take the position that uncertainty about the subject of climate change and its causes and consequences meant that it could be left out of account. Matters of a systemic nature or carrying material long-term implications are properly to be identified as such.

VI It is relevant and appropriate for pension fund trustees to consider what would beneficiaries as a body ask and want to know before a decision is made or about a decision made. Pension fund trustees may be better placed than advisers and investment managers to consider this; it is one of the respects where pension fund trustees bring their qualities to the decision-making required. They should have confidence through the fact of their appointment as pension fund trustees.

VII In law, the exercise of judgment is permissible (indeed, necessary) for pension fund trustees when making decisions. The judgment will usually be informed and assisted by advice, but the judgment is that of the pension fund trustees. The reasons for it should be capable of being explained. For all the views or advice available, there is no one else, other than the pension fund trustees, with the authority to bring human judgment into the key decisions that will need to be made by a pension scheme. The fiduciary duties of the pension fund trustees focus that judgment on the purpose of the scheme and on the interests (under the scheme’s trust) of its beneficiaries. Without that judgment, an important part of the checks and balances that are needed are unavailable to the scheme.

7.4 The subject of consultation with beneficiaries is sometimes raised. This would be for views, not for advice. It will still leave the pension fund trustees with the decision to make, and with the responsibility for it. But it is right to acknowledge that new techniques of consultation are being developed in this and other fields.

43 The fact that the employer may have various interests has been noted earlier (see footnote 4). In appropriate circumstances the employer’s view, or consideration by the pension fund trustees of what the employer would ask and want to know, may be relevant. Note that under the Occupational Pension Schemes (Investment) Regulations 2005 before preparing or revising a statement of investment principles, the trustees of a trust scheme must consult the employer (regulation 2(2)). The regulation applies in the context of Section 35 of the Pensions Act 1995, and subsection (5) of that provides that: “Neither a trust scheme nor a statement of investment principles may impose restrictions (however expressed) on any power to make investments by reference to the consent of the employer.”
Where the technique is robust, seeking views may sometimes contribute to the management of the risk of litigation. But more fundamentally it may offer insight, or avoid misconceptions.

8. **“Numbers and narrative”**

8.1 Pension fund trustees have to decide investment strategy, principles and policies. Approaching a decision with regard to financial factors does not mean that it will be a decision made simply by pointing to a number (e.g. a metric or a financial projection). Pension fund trustees will need to expect that the reasons for their decision, made with regard to financial factors, should involve both numbers and words ("numbers and narrative").

8.2 Take the situation where pension fund trustees have considered relevant matters, in the interests of the scheme and the interests (under the scheme’s trust) of its beneficiaries, and have taken into consideration what their advisers and investment managers have to say. In some circumstances an investment with a return expressed as a number might be declined by the pension fund trustees (or be declined by the investment manager on their behalf, in accordance with a strategy they have set or investment principles or policies they have agreed) because of a risk expressed in words.

8.3 Sometimes financial factors cannot be quantified but it does not follow that they lack weight. The further the time horizon the more that a number (which in that context is at best a projection) may be speculative. Where sustainability and the subject of climate change is concerned, it may be difficult for associated risk and returns to be fully understood if expressed simply as a number. At least some of the effects of the subject of climate change fall into the category of outcomes to which it may be difficult to attribute probabilities but which are nonetheless material and could be judged sufficiently important to warrant being taken into account.

8.4 These points are highly relevant to advisers and investment managers in their work to support pension fund trustees. Rigorous qualitative and not simply quantitative consideration is now more important in the pension sector. It can be expected to assist the effort to achieve decisions in relation to a pension fund that are based on a balanced and informed judgment, in context and with attention to relevant time horizons.

8.5 Available forms of assistance are increasing, including through developments in disclosure requirements for companies and in markets, and more generally through national and international regulatory, treaty and best practice frameworks.

9. **Portfolios, and investing in pooled or passive funds**

9.1 It is appreciated that pension fund trustees generally do not direct specific day-to-day investment decisions. Nevertheless they will monitor the work of the investment manager, whether the investment is by way of segregated mandates,  

---

44 Developments in International Financial Reporting Standards (IFRS) are an example with potentially significant impact. See also the Sustainability Disclosure Requirements recently published by the Financial Conduct Authority: [PS23/16: Sustainability Disclosure Requirements (SDR) and investment labels (fca.org.uk)](https://www.fca.org.uk). The latter does not appear to apply to pension fund trustees acting as trustees, but consider the position of some trustee corporations regulated by the FCA and some service providers. The broader point is that quite apart from the question of direct or indirect applicability of particular regulatory standards or requirements, universally or generally accepted standards or requirements of reporting may change markets in time, and this too is relevant to the assessment of risk and return today.
pooled funds or otherwise. Regardless of any delegation, investment decisions need to be reached not in isolation but within the context of the broader portfolio of the pension fund. The pension fund trustees are also responsible for setting the investment strategy, principles and policies both at the level of the fund and in the context of individual investment manager relationships. Asset allocation will generally be an important part of this.

9.2 These are further areas where what has been said above on “numbers and narrative” is key. It is still important to know enough, using available materials and reports and through enquiry of advisers and investment managers, about the underlying investments so as to allow risk and return to be assessed rigorously but realistically before decisions are made, and to monitor the full consequences for the fund thereafter.

9.3 If that is not being addressed asset by asset at the level of the pension fund trustees’ decision-making then the trustees will still want to know where and how it is being addressed. Where the “return” is a net figure to which different parts of a portfolio or a pool are expected to contribute it is important that this does not mask any material part of the risk from any part of the portfolio or pool. Similar considerations apply where investment is in a passive fund, tracking an index or a variation of an index.

9.4 These are among the considerations that will themselves further inform the investment strategy that the pension fund trustees will decide, and the investment principles or policies that they will adopt and any specific provisions they will seek to agree with investment managers. Given the significance of sustainability and the subject of climate change in the consideration of financial factors they are now more important than ever.

10. **Stewardship after the decision to invest**

10.1 The stewardship of an investment once made may be material to achieving or maintaining (or improving) the balance of financial risk and return that was assessed when the decision to invest was made.

10.2 Stewardship involves using rights and benefits acquired by the investment. It is, in effect, a logical progression of the ongoing exercise of the investment power by the pension fund trustees. Given the significance of sustainability and the subject of climate change, the concept of stewardship may be said to include them when they affect the likely risks and returns on the pension fund’s investment portfolio over time.

10.3 There are examples of in-house stewardship by pension funds themselves. In other cases, in practice stewardship (which will need to be proportionate and cost-effective) is likely to be carried out on pension fund trustees’ behalf by their investment managers. Pension fund trustees will wish to have processes for the proper communication of their stewardship expectations and proper oversight of the investment managers’ work to reassure themselves of its effectiveness in mitigating risks and supporting returns.

---

45 An important point to keep in mind is that there may be an appreciable “timing mismatch” between goals set by pension fund trustees and their realisation by investment managers. This is a point that may repay further consideration in the sector so as to identify available strategies to address the point.
Corporate strategy, structure, governance, culture and purpose, among other aspects to which stewardship is addressed, may all be relevant to risk and return, now and in the future.\(^{46}\)

Cost-effective steps to encourage responsible corporate behaviour by investees or potential investees generally in the context of sustainability and the subject of climate change may be proper steps for pension fund trustees to take or encourage, including through the work of investment managers.

For practical reasons, and to increase effectiveness, stewardship in the context of sustainability and the subject of climate change may at times be an area for steps to be taken collectively by and in the interests of the pension fund among other investors.

11. **The time ahead**

11.1 As shown, pension fund trustees will address risk, including systemic risk, and return.

11.2 This will include taking into account which investments and which investees address risks in the context of sustainability and the subject of climate change, and which do not. So too, which address return in that context, and which do not. This is relevant to the proper exercise of investment power, and that is a matter for all pension schemes.

11.3 If pension fund trustees approach their fiduciary obligations today in the context of sustainability and the subject of climate change and with advice and assistance, their approach can be expected in turn to inform how investees measure success and identify, address and monitor risk and return.\(^{47}\) That (and related increased transparency) may in turn help pension fund trustees still further to meet their fiduciary obligations. Sometimes the pension fund may need to initiate this reinforcing process.

11.4 In the time ahead, pension fund trustees will, with advice and assistance, further develop their understanding of the financial risks presented by sustainability and the subject of climate change, as well as related opportunities for value creation. This may reveal additional effective ways of managing risk and supporting returns.

11.5 Any assessment of the prospects of effectiveness in managing risk and supporting returns at the level of an individual pension fund could be very different from an assessment of the prospects of effectiveness when collaborating or coordinating with others. Pension fund trustees may consider that the pension fund for which they are responsible faces climate change-related risk but that risk cannot be materially addressed by the pension fund alone. Pension fund trustees are able to discuss with their advisers and investment managers, whether there are appropriate, lawful\(^{48}\), cost-effective steps available to be taken in collaboration and coordination with other pension funds. At least some reliable transparency on the approach of others may help.

---

\(^{46}\) Law Com No 374 at 2.29 suggested that “there is no duty on pension trustees and managers to undertake stewardship activities, or even to consider whether they should undertake these activities.” This proposition is open to question, for example where stewardship could improve sustainability and thereby reduce risk and increase return. Note also regulation 2(3)(b)(vi) and (c) of the Occupational Pension Schemes (Investment) Regulations 2005; and see also Law Com No 374 at 5.12 and fn 115.

\(^{47}\) In this regard, consider generally the work of The British Academy on The Future of the Corporation: see https://www.thebritishacademy.ac.uk/programmes/future-of-the-corporation/.

\(^{48}\) It is outside the scope of this paper to consider the circumstances where collaboration is lawful, and legal advice should be taken.
11.6 Subject to advice and where relevant, consultation with the employer may also suitably develop further in the time ahead. It is to be anticipated that the approach of pension fund trustees may help employers in meeting their own sustainability goals. And of course, some of those employers may also be investees for other pension funds.

11.7 This paper has concentrated on the area of sustainability that involves the subject of climate change. It will be apparent that the considerations may be relevant to other areas too. These may include nature, environment, community, and biodiversity. In each case the lens is that of the purpose of the scheme and the proper, lawful use of trustee powers to achieve that purpose (including by reference to applicable time horizons), based on an appropriate decision-making process.

11.8 This paper has not needed to refer to the term “quality of life” save to acknowledge the use of the term by the Law Commission in its earlier reports. Of course financial factors (which, as discussed, must be taken into account, and which are broad) may at the same time be factors that go to beneficiaries’ quality of life. The fact that they do so does not make them any the less a financial factor.

11.9 As stated at the outset, this short paper is not advice. As it has emphasised, pension fund trustees are generally supported by the contributions of advisers and investment managers. Where the combination of different contributions made by each are fully recognised and delivered well, beneficiaries will be even better served. Of course, legal and investment analysis will continue to develop in the years to come and it is important that this happens.

6 February 2024
FMLC Members

Lord Thomas of Cwmgiedd (Chairman)

Andrew Bagley, Goldman Sachs International
Sir William Blair, Queen Mary University of London
Claude Brown, Reed Smith LLP
Raymond Cox KC, Fountain Court Chambers
Simon Firth, Linklaters LLP
Kate Gibbons, Clifford Chance LLP
Jonathan Grant, Bank of England
Professor Louise Gullifer KC (Hon), FBA, University of Cambridge
Carolyn H. Jackson, Katten Muchin Rosenman U.K. LLP
Rachel Kent, Hogan Lovells (International) LLP
Peter King, HM Treasury
Sir Robin Knowles CBE
Ida Levine, Impact Investing Institute
Karen Levinge, Financial Conduct Authority
Jon May, Marshall Wace LLP
Chris Newby, AIG
Conall Patton KC, One Essex Court
Bob Penn, Allen & Overy LLP
Jan Putnis, Slaughter and May
Barnabas Reynolds, Shearman & Sterling LLP
James Smethurst, Freshfields Bruckhaus Deringer LLP
Tom Smith KC, 3-4 South Square
Sanjev Warna-kula-suriya, Latham & Watkins LLP

Brian Gray (Chief Executive)

Registered Charity Number: 1164902.
"FMLC" and "Financial Markets Law Committee" are terms used to describe a committee appointed by Financial Markets Law Committee, a limited company ("Company"). Registered office: City of London, PO Box 270, Guildhall, London EC2P 2EJ. Registered in England and Wales with number: 8733443