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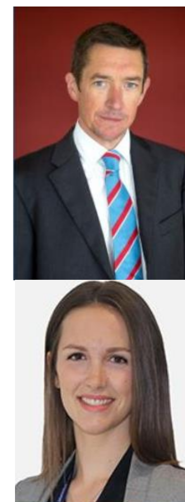
Theme: Environmental, Social and Governance Considerations in Pension Plans

Pension Schemes – A Superpower in the Fight Against Climate Change?



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1. Introduction

Speaking at the United Nations Climate Change Conference ("COP26") in October 2021, the UK Secretary of State for Work and Pensions, Thérèse Coffey, said that pension schemes can become a "superpower" in fighting climate change and propelling the world to net zero. But to what extent does the legal landscape within which pension schemes operate allow them to perform this role, and indeed to what extent should they be performing this role?

Here in the UK, we have seen a recent influx of legislation which has cemented ESG and, specifically, climate change as factors which pension schemes must incorporate into their investment strategy and which has introduced stewardship and ESG and climate–related reporting obligations. This led us to wonder whether similar legislation exists in other major pensions jurisdictions. Our findings are set out in this article, which is a high-level comparative analysis of the extent to which the law in the UK, the US, the Netherlands, Australia and Canada[1] promotes, or even permits, pension schemes investment by pension schemes in a way which takes account of ESG factors. We focus on the laws and non-binding codes and guidance relating to the selection of investments, stewardship and reporting.

The focus of this article is on the law as it relates to pension schemes and their trustees or equivalent governing bodies. There are many other stakeholders involved in the investment process, notably investment managers and financial product providers, which may be subject to separate obligations. The obligations in respect of these other

[1] These are the countries in which the greatest value of assets is held by retirement savings vehicles (Organisation for Economic Cooperation and Development, 'Pension Funds in Figures', June 2021).

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stakeholders are outside the scope of this article.

In this article we refer to "ESG" or "ESG factors". "ESG" stands for environmental, social and governance. Climate change is included within this umbrella term, as one of the environmental factors. Only where there are requirements which specifically target climate change do we refer to climate change as distinct from ESG.

2. Investment: To what extent does the law promote pension schemes taking account of ESG in their selection of investments?

United Kingdom

In the UK, pension scheme trustees' investment duties are governed by a mixture of common law and statute. The common law fiduciary duty is typically summarised as a requirement to act in the best interests of members. This was historically seen as preventing trustees from taking account of ESG factors in their investment strategy but the past 10-15 years has seen a paradigm shift in favour of a recognition that there is a strong correlation between ESG factors and trustees' fiduciary duties.

Nonetheless, the Government felt that not enough trustees were giving ESG factors due consideration. To remedy this, on 1 October 2019 it revised the legislation governing pension scheme Statements of Investment Principles[2] by requiring trustees to address the following further requirements:

(a) the trustees' policy in relation to "*financially material considerations*" (which is expressly stated to include ESG considerations) underlying the investments, including how those considerations are taken into account in the selection, retention and realisation of investments; and

(b) the extent, if at all, to which "*non-financial matters*" (which includes the views of scheme members on social and environmental impact) are taken into account in the selection, retention and realisation of investments.

Whilst these requirements do not require trustees to invest in a way which promotes ESG considerations, they codify the notion that ESG factors are, or at least can be, inherently financial. The distinction in the treatment of financially material considerations and non-financial matters is equally telling - whilst the Government is keen to encourage schemes to take account of ESG factors, it is reluctant to allow trustees to do so at the expense of members' financial interests.

Netherlands

As an EU member state, the Netherlands is subject to the IORP II Directive[3] which requires pension funds to have an effective system of governance and risk-management in place which considers, among other things, ESG factors in relation to a scheme's investment portfolio and investment policy. This requirement sits alongside the broader duties on pension funds to invest in the interests of the pension scheme members. Like the UK therefore, the legislation in the Netherlands

[2] Occupation Pension Scheme (Investment) Regulations 2005 (SI 2005/3378) – the "Investment Regulations". These require occupational pension schemes with over 100 members to produce and maintain a Statement of Investment Principles which governs how they make decisions about the investment of the scheme's assets.

[3] Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs).

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requires pension fund board members to consider ESG factors in developing their investment policy, but leaves it to the pension fund board members to determine the extent to which they do so in light of their fundamental duty to invest in the interests of the members.

United States

The situation is less clear-cut in the US, where the ability of pension schemes lawfully to take account of ESG factors in investment strategy was dealt a serious blow by the Trump Administration's Department of Labor's ("DOL") 'Financial Factors in Selecting Plan Investments' rule effective 12 January 2021. This rule, which is legally binding, iterated that all pension scheme investments must be based solely on financial factors (i.e. those that have a material effect on an investment's risk and return based on appropriate time horizons consistent with the plan's investment objectives and funding policy). The rule has made it difficult in practice for pension schemes to take account of ESG factors in investment decision-making due to the 3 Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of need to demonstrate that such factors are purely pecuniary in nature.

In March 2021, the Biden Administration DOL issued an enforcement statement announcing that, until it releases further guidance, it will not pursue enforcement action against any pension plan fiduciary based on a failure to comply with the ESG Rule with respect to an investment. To reinforce this position, the DOL issued a Notice of Proposed Rulemaking (the "Notice") on 13 October 2021 that would amend the investment duties regulation under ERISA which addresses the duties of prudence and loyalty in selecting plan investments. The Notice retains the core principles that the duties of prudence and loyalty require that fiduciaries focus on material risk-return factors and do not subordinate the interests of participants and beneficiaries to objectives unrelated to the provision of plan benefits. An important change in the Notice is the proposed addition of regulatory text which clarifies that, when considering projected returns, a fiduciary's duty of prudence may often require an evaluation of the economic effects of climate change and other ESG factors on the particular investment. However, unless and until the proposed amendments are adopted, a private litigant could still bring action against a pension scheme fiduciary for failure to comply with the ESG Rule and so there is still risk to schemes which give undue preference to ESG factors.

In light of the above, the current legal landscape in the US cannot be said to promote pension schemes to engage with ESG when selecting scheme investments.

Canada

Provincial and Federal pension legislation does not expressly require pension schemes to take climate change into account in the selection of scheme investments. That said, it is well-established in law that plan administrators are fiduciaries and have a fiduciary obligation to plan members. This fiduciary obligation inherently requires pension administrators to take into account financial risks and opportunities, which may include those that stem from ESG factors, when managing and investing plan assets.

Whilst the legal position in Canada is not substantively different from the US, the political and regulatory climate is more disposed to pension schemes taking into account ESG factors and so the risks of a scheme being successfully challenged for taking account of such factors is lower. The law in Canada can therefore be said to permit, rather than promote, pension schemes taking account of ESG factors in investment.

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Australia

As with Canada, there is no Australian legislation which expressly prescribes a duty for pension schemes to consider or account for ESG in their investment strategy, and so pension schemes must fall back on their broader duties under the Superannuation Industry (Supervision) Act, 1993 (the "SIS Act") to act in members' best interests. However, a series of highly influential legal opinions from the Australian Centre for Policy Development, which have subsequently been referenced with approval by all of Australian's major financial regulators, point to the fact that:

(a) consideration of material climate risks falls within the fiduciary duty of directors (under the Corporations Act 2001) and trustees of superannuation funds (under the SIS Act) to exercise their powers and discharge their duties with a degree of reasonable care and diligence; and

(b) climate change risks should be assessed as a financial risk.

It is considered that, as a minimum, trustees legally can and should consider whether, and to what extent, ESG risks affect the pension scheme and its investments in the short, medium and long term and, where the risks are sufficient, trustees are arguably compelled to act in respect of these risks in order to discharge their duty of care and diligence.

3. Stewardship: To what extent does the law promote pension schemes engaging with the entities in which they invest?

United Kingdom

Amendments to the Investment Regulations in 2019 require trustees to include within their SIP their policy in relation to (i) the "*exercise of rights*" (including voting rights) attaching to the investments and (ii) undertaking engagement activities in respect of the investments, including engagement with the companies in which the scheme invests and the scheme's investment managers on, among other things, social and environmental impact and corporate governance.

As with the position on climate change in scheme investment, the legal obligations here require trustees to develop and to articulate a policy on their approach to stewardship, and in so doing strengthen the obligations on trustees to promote stewardship of scheme investments without imposing specific stewardship obligations.

Netherlands

Dutch pension funds that hold investments in listed companies fall within the scope of the Dutch Stewardship Code ("Code"), which integrates the new stewardship obligations derived from the EU Long-Term Shareholder Engagement Directive.[4] The Code requires pension funds to comply with, and report on their compliance with, the 11 principles of the Code or declare via a public statement why they have chosen not to comply with one or more of the principles. The principles include:

(a) having a public stewardship policy that describes how the scheme integrates stewardship of Dutch listed investee companies in their investment strategy;

[4] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement.

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(b) monitoring Dutch listed investee companies on material issues, including environmental impact;

(c) being prepared to enter into dialogue with the directors of the Dutch listed companies in which the scheme invests and to escalate stewardship activities in cases where issues remain unresolved.

By adopting a "comply or explain" approach, the Code does not mandate pension funds to take a particular course of action, but exerts pressure on them to engage actively with the public companies in which they invest by requiring pension funds which wish to opt out of any of the principles to justify their position to do so.

The Code is, however, far from comprehensive as its application is limited to Dutch listed companies and it is not legally binding.

United States

In the US, pension schemes are not currently subject to any mandatory legal requirements and/or non-mandatory guidance to engage with the entities in which they invest.

Canada

Provincial and federal pension legislation does not expressly require pension schemes to engage with entities in which they invest. However, pension schemes have a general obligation to monitor, review and assess material disclosure (which would include ESG factors) from entities in which they invest and appropriately manage plan assets in a manner consistent with the primary financial purpose of the pension plan. Whilst this obligation does not expressly require pension schemes to engage with investee entities, there is no doubt that doing so would be consistent with this obligation.

Australia

Pension schemes are not currently subject to any mandatory stewardship obligations under Australian statute.

4. Reporting: Are pension schemes subject to legal requirements to report on their climate change-related investment activities?

United Kingdom

Requiring pension schemes to report on their ESG and climate-related activities is the primary focus of the recent regulatory changes in the UK. Following these changes, occupational pension schemes are now required to publish the following on a publicly available website:

- the SIP (which must now cover climate change and ESG considerations and their policy towards stewardship – see sections 2 and 3 above);
- an 'Implementation Statement' detailing how the scheme's policies in the SIP have been followed and describing the voting behaviour by, or on behalf of, the trustees;
- a report which details the extent of their compliance with the Task Force on Climate-Related Financial Disclosures ("TCFD") recommendations on the disclosure of climate-related financial risks and opportunities, which have been transposed into legislation (this

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obligation is limited to the largest schemes[5]).

The focus of the UK Government on disclosure is another means of pushing pension schemes to incorporate ESG factors to the heart of investment strategy without changing trustees' fundamental fiduciary duties. The requirement to publish publicly, rather than simply to members, is particularly interesting as it appears intended to harness external pressure from climate activist groups and public opinion in an attempt to move more resistant pension schemes to embrace ESG factors.

Netherlands

The IORP II Directive requires pension funds to produce a public statement of investment policy principles which documents how their investment policy takes ESG factors into account.

Pension funds are required under the Dutch Pensions Act[6] to include in their management report (which is part of their annual report) a statement on how their investment policy takes account of climate change, human rights and social relations. The actuarial report of the pension fund must also include its IORP II statement of investment principles which must state how ESG factors are taken into account in the investment policy. Both the annual report and actuarial report of pension funds must be provided to the Dutch pension regulator and the Dutch National Bank. These reports must also be provided to former participants and retirees in the pension scheme upon request. The EU Disclosure Regulation[7] and Taxonomy Regulation[8] also introduce a new framework for sustainable finance disclosure under which EU pension funds must, among other things, publish information on their websites about the integration of sustainable risks into their investment decision-making process.

The Dutch Stewardship Code (see section 3 above) requires pension funds that fall within the scope of the Code to report annually (in the annual report and on the fund's website) on how they have implemented their stewardship policy and if and how it has integrated that policy into its arrangements with its asset managers. Furthermore, the IMVB Covenant,[9] a sector covenant on identifying, prioritising and addressing ESG risks, requires participating pension funds to draw-up their ESG policy as soon as possible after 1 January 2019 and ultimately before 30 June 2021. Although the IMVB is not legally-binding and participation is voluntary, more than 80 Dutch pension funds, which together account for around 90% of the total assets managed by Dutch pension funds, have signed the IMVB Covenant.

Similar to the UK, it is clear that both Dutch legislation and industry guidance puts a heavy emphasis on pension funds reporting against ESG-related obligations and providing this information publicly.

United States

There is no legal requirement in the US for pension schemes to report on the incorporation

[5] The requirement to comply with the TCFD requirements currently applies to schemes with an asset value of over GBP 5bn and master trusts; from October 2022 it will apply additionally to schemes with an asset value of GBP 1–5bn.

[6] *Wet van 7 december 2006 houdende regels betreffende pensioenen (Pensioenwet)* (Act of 7 December 2006 concerning regulations with respect to pensions, Dutch Pension Act).

[7] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.

[8] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088.

[9] Convenant Internationaal Maatschappelijk Verantwoord Beleggen (International Socially Responsible Investment Covenant for Pension Funds).

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of ESG factors in investment activity. The law requires the general disclosure of all of a pension schemes' investments to scheme members and government regulators. Unlike in the UK and the Netherlands, it is difficult for scheme members and the general public to obtain the information they would need to assess a pension scheme's approach to ESG.

Canada

Ontario is currently the only Canadian jurisdiction with a statutorily-mandated ESG disclosure requirement — it requires all registered pension plans to disclose in their Statement of Investment Policies and Procedures whether ESG factors are incorporated into the plan's investment strategy and, if so, how. The Federal Government is currently deciding whether it should require such disclosure for federally regulated pension plans.

Australia

Climate-related reporting obligations for pension schemes in Australia are not expressly prescribed in legislation. However, as with climate-related investment obligations, they are arguably derived from Australian law on fiduciary duties. Where the risks arising from climate change are material, disclosure obligations for pension schemes may apply under the Corporations Act 2001, for instance in relation to directors' reports, annual financial reports and obligations of continuous disclosure. Further, in a recent case against the Retail Employees Superannuation Trust,[10] a member argued that he was entitled to be provided with a range of information relating to how the fund was managing climate risk, based on his right under the Corporations Act 2001 to access information that he reasonably required to make an informed judgement about the management, financial condition and investment performance of the fund, or of particular investments. The case settled but the terms of settlement were widely viewed as a strong signal to the pensions industry that climate risk is likely to be considered a material financial risk in many cases.

5. Conclusions

It is clear from our analysis of these legal landscapes that they differ substantially in the extent to which they promote pension schemes engaging with climate change.

There is little doubt that Europe is at the cutting edge of ESG-focused legislation. Much of the new legislation focuses on schemes incorporating ESG into their broader investment governance processes and reporting against their obligations. In doing so, it uses two main devices, comply or explain and disclosure, which pressurise, rather than compel, pension schemes to take a particular course of action. As such, the new legislation works around, rather than seeks to change, fundamental trustee duties, which are focused on securing the optimal financial outcome for members.

There is a strong correlation between ESG factors and fiduciary duties, with many of these factors being linked to a reduction in an investee company's value in the longer term, and this has been recognised by legislators in Canada and Australia, where requirements for pension schemes to engage with climate change largely derive from the wider duties of scheme fiduciaries. In both of these jurisdictions, we are, however, beginning to see the green shoots of express requirements on schemes to engage with ESG.

In the US, the DOL's exclusion of ESG factors from the matters which scheme fiduciaries can

[10] *McVeigh v Retail Employees Superannuation Pty Ltd* [2019] FCA 14.

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consider when determining investment strategy has had a negative impact on the willingness of scheme fiduciaries to engage with climate change and, to date in the US, there has been markedly less regulatory development that encourages schemes to engage with climate change than in the other four jurisdictions covered by this article. The recent Notice of Proposed Rulemaking of October 2021, which states that a fiduciary's duty of prudence may often require an evaluation of the economic effects of climate change and other ESG factors on an investment, marks a shift in policy direction away from the previous administration. Nonetheless, the Notice is yet to be adopted and the position remains sensitive to the wider political climate.

Even in the most progressive jurisdictions, schemes are far from being "superpowers" in fighting climate change and propelling the world to net zero. Very few UK schemes have, for example, made net zero commitments. The reluctance of schemes to do so is understandable — their purpose is to provide a retirement income for their members and, whilst there is a correlation between that and managing ESG factors, there is a point at which the two considerations diverge. This is recognised in the UK legislation — schemes are required to record in their SIPs the extent, **if at all** (our emphasis) to which nonfinancial matters are taken into account in investment. This follows legal analysis[11] that schemes may only take account of non-financial factors where there is no risk of material financial detriment to the fund and good reason to think that scheme members would share the concern. Schemes which have made net zero commitments will need to ensure that this is not at the expense of scheme members and will need the evidence to support this.

The UK politicians are right to recognise pension schemes as an ally in the fight against climate change as (i) with their longer term investment horizons, pension schemes need to take into account ESG factors, and (ii) with the large amounts of capital which they hold, they are significant players in the economy. But it is a mistake to assume that the interests of pension scheme members, and correspondingly the duties of trustees, are wholly aligned with the fight against climate change. Describing them as "superpowers" was a well-intentioned piece of political rhetoric in the context of COP26, but some way off the mark in reality.

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[11] Law Commission – Fiduciary Duties of Investment Intermediaries – 2014.

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