



## THE LAW COMMISSION

### PENSION FUNDS AND SOCIAL INVESTMENT

This optional response form is provided for consultees' convenience in responding to our call for evidence on pension funds and social investment.

The response form includes the text of the questions in the call for evidence, with boxes for yes / no answers (please delete as appropriate) and space for comments. You do not have to respond to every question. Comments are not limited in length (the box will expand, if necessary, as you type).

Each question gives a reference in brackets to the paragraph of the call for evidence at which the question is asked. Please consider the surrounding discussion before responding.

We invite responses from 7 November 2016 until **15 December 2016**.

Please return this form:

By email to: [commercialandcommon@lawcommission.gsi.gov.uk](mailto:commercialandcommon@lawcommission.gsi.gov.uk).

By post to: Lucinda Cunningham, Commercial and Common Law Team,  
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Post Point 1.53, 52 Queen Anne's  
Gate, London SW1H 9AG

We are happy to accept responses in any form. However, we would prefer, if possible, to receive emails attaching this pre-prepared response form.

**Freedom of information statement**

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If you wish your information to be confidential, please tell us why you regard the information as confidential. On a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not be regarded as binding on the Law Commission.

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**CONFIDENTIALITY**

Do you wish to keep this response confidential?

Yes:	No: ✓
If yes, please give reasons:	

## QUESTION 1: BARRIERS TO PENSION FUND INVESTMENT

(Call for evidence, paragraph 1.15)

What are the barriers to pension funds investing:

- (a) In infrastructure generally?
- (b) In socially significant infrastructure?
- (c) In other forms of social investments?

The following are potential barriers to default pension funds investing in infrastructure, social infrastructure and/or social investments (as specified where separate):

1. Pension trustee's powers of investment are particularly wide (s34 Pensions Act 1995). However, it is subject to "any restrictions imposed by the scheme", such that it is possible that investment powers may be restricted by the pension scheme documentation such as to rule out or have the effect of ruling out investments in infrastructure/social investments;
2. Moreover, although the power in s34 is expressed to be akin to beneficial ownership, it does not mean that it is open to trustees/fund managers to take a degree of risk which a person may do with his or her own investments. The investment duties of trustees/fund managers, including particularly the fiduciary, common law care and skill and specific statutory investment duties applicable to pension trustee when concerned with positive decisions to be made in respect of default funds where the specific consent of the beneficiaries to the investment in a particular fund/asset is not forthcoming, may not fit particularly easily with the present offerings for infrastructure/social investments on the market.
3. One particular point here is that, in considering whether a trustee has complied with her/her duty, a Court will apply the standard of an ordinary prudent man of business, which standard will be higher in the case of a professional. The duty includes an obligation to avoid excess levels of risk. In considering these questions a Court will have regard to contemporary investment practice. It is perhaps a case of 'chicken and egg', but until social investments become more attractive and 'mainstream', a cautious trustee may consider more traditional investments simply safer and hassle free (and less costly, since a particularly risk adverse trustee may, in the context of the

social investment, feel the need to seek not only financial, but also legal advice on the powers and duties of investment in this field). Similarly, while private equity or sovereign wealth funds may be more willing to invest in riskier and more uncertain infrastructure type projects, pension trustees/fund managers will on the whole likely take a far more cautious approach to investing default funds.

4. In particular, Paras 4 & 4A of the Investment Regulations (SI 2005/3378) (“the 2005 Investment Regs”) require that, regardless of the size of the scheme, assets in a default arrangement must be invested in the best interests of members, and where the scheme has more than 100 members, the power of investment must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole, and fund assets must be invested in a manner appropriate to the nature and duration of the benefits payable under the scheme. In so far as there is reluctance among pension trustees/investment managers to invest default funds in infrastructure/social investments, it is likely because they do not, or it is not obvious or clear, that they meet or are likely to meet these criteria. Questions of liquidity and the manner of investment are obviously important, particularly with the need to invest for particular members in low risk, easily accessible assets, which in the absence of a ready market to buy and less social investments will create a difficulty for schemes. Equally, while a riskier investment profile may be suitable for younger members, it will need to be a profitable investment, and there may be some difficulty with investments where the return is uncertain, speculative or low, or is perceived to be such, compared to traditional type investments. There may also be a perception that social investments are more high risk and thus less secure in terms of return, and demands of a higher yield to compensate for that risk may create impediments in the marketplace. In the absence perhaps of some form of government backing or guarantee behind a social investment, this may create a particularly high hurdle to overcome.
5. More particularly, paras 4(5) & (6) of the 2005 Investments Regs specifically require that assets of the scheme with 100 or more members ‘must’ consist predominantly of investments admitted to trading on regulated markets, and assets which are not so invested must be kept to a prudent level. In so far as an infrastructure/social investment opportunity is otherwise on a regulated market, it may prove particularly difficult for funds, save for the largest funds, to be invested or invested to a significant extent therein.
6. A similar issue arises from the requirement in Para 4(7) of the 2005 Investment Regs to all schemes to diversify, particularly for all but the largest

funds.

7. Further, by s35 Pensions Act 1995 and paras 2 & 2A of the 2005 Investment Regs trustees of schemes with 100 or more members are to produce a statement of investment principles, explaining the aims and objectives in respect of investments and policies and how they are intended to ensure the assets are invested in the best interests of the group of the members investing in a default arrangement. It may prove difficult to explain why a social investment, which may not produce as high a return as a more traditional investment, or a risky infrastructure project (which have a propensity to overrun and exceed budgets) are in their best interests. But even if this can be overcome, it may prove to be administratively unworkable to determine or attempt to divine what type or types of infrastructure / social investments are for the best interests of the relevant group, particularly if they are large and diverse. Aligned with this is the issue as to the definition or determination of 'social' investments: one member's 'social' investment may not chime with another member's viewpoint; similarly, reasonable people can and do take very different views on infrastructure (e.g. HS2, Heathrow's Third Runway, nuclear vs green energy, etc). Moreover, the particular explanation will also likely need to be rather larger than with traditional investment strategies, covering the justification for investing in particular social issues perhaps to the exclusion of others, which again may put trustees off considering them for investments.
8. By Para 2A of the 2005 Investment Regs, there is also an obligation on larger schemes to regularly review and revise the investment strategy, including by reference to the return on investments. There is also an obligation on trustees to regularly value their funds and investments and also provide information to members of the value of their pension. One issue with infrastructure and/or social investments may be one of valuation (both the administrative workability and expense of obtaining the valuation, and the question of how a social investment might actually be valued) of the investment asset in question, or at least a regular valuation, compared with more traditional investments on the regulated market.
9. For the purposes of producing a statement of investment principles, trustees must obtain and consider appropriate advice. Moreover, trustees have the power to delegate actual decisions as to investments (and usually do so). To this end, there may be an issue whether there exists in the marketplace suitably qualified advisors/investment managers who have the necessary expertise to make appropriate investments in infrastructure/social investments, alongside more traditional investments or otherwise, and/or of a

sufficiently diverse nature to meet the trustee's duties. In particular, it may be that in order to meet the requirement of diversification, a number of investment managers will need to be employed for these purposes, adding significantly to the costs of administering the fund.

10. Overall, we are of the view that the barriers to investment are not so much the relevant powers/duties imposed on trustees/fund managers in respect particularly of default arrangements. They have developed sensibly over the years to produce a prudent and acceptable level of protection for members. In so far as there is a resistance to investing in infrastructure / social investments, it may perhaps be due to the present offerings not, from the perspective of a default fund, being sufficiently well known, diverse, attractive, in a readily investable form and/or at an acceptable level of risk. In other words, the barrier to such investments may not in truth be the law itself, but rather the investments as a package themselves, such that it is not necessarily the law governing investments which may need to adapt, but the investment offerings.

## QUESTION 2: LEGAL AND REGULATORY BARRIERS

(Call for evidence, paragraph 1.15)

Do any of those barriers (identified in Question 1) relate to issues of law and regulation?

Yes:		
In 1-9 (as detailed therein), save for the observations in 10.		

### QUESTION 3: SIZE OF PENSION FUNDS

(Call for evidence, paragraph 1.15)

Is the size of funds a major issue? If so, are there legal obstacles to scheme mergers?

Yes:		
<p>Larger funds (your Scottish Widows and Avivas), which have deeper pockets, access to quality advice and investment management and can offer a wider and more diverse range of investments, are less likely to be hamstrung by the matters set out in answer to Q1 above when considering, for the purposes of default arrangements, investing in infrastructure / social investments.</p> <p>The issues arise more in relation to smaller funds and master trusts, and it is understood that there is a move to increase their size, including by merger.</p> <p>The legal route to a merger is essentially by the bulk transfer of assets and liabilities from one scheme (usually the smaller one) to another (usually the larger one), or by both schemes transferring to a newly established scheme. It is often (but not always) accompanied by the winding up of the transferor(s).</p> <p>There are not so much legal 'obstacles' to such mergers, but rather a legal 'process' to follow and practical/commercial issues to consider.</p> <p>The first part of the process is to determine whether there is sufficient power within the terms of the scheme documentation to allow a bulk transfer.</p> <p>If so, conditions for its effective exercise are usually stipulated, such as obtaining employers/members' consent. There may also be employment related issues to consider, including whether any particular assurances have been made to employee members.</p> <p>Where member's consent is not forthcoming, an occupation pension scheme may permit a bulk transfer where the conditions of paragraph 12 of the Occupational Pension Schemes (Preservations of Benefits) Regulations 1991/167 are first satisfied. In essence, for stakeholder money purchase schemes under trust this means the transferring scheme (another occupational scheme or a personal pension) has commenced winding-up and the transfer payment is of an amount at least equal to the cash equivalent of the member's rights under the scheme as calculated and verified in prescribed circumstances. Otherwise, the transfer will need to be to another occupational pension scheme where there will need to be a</p>		

employment connection between the schemes and the transferring member will acquire transfer credits broadly no less favourable than the rights being transferred.

Subject to that, as with Q1, trustees when exercising their power are subject to fiduciary duties to act within and for the purposes of their power, in the best interests of the members and taking into account all relevant factors and ignoring irrelevant factors.

For those purposes, the commercial terms of the transfer will be all important.

Overall, however, from our perspective it is not known what of these hurdles actually creates practical impediments to mergers.

#### **QUESTION 4: ETHICAL PENSION OPTIONS**

(Call for evidence, paragraph 1.18)

We wish to hear from employers and pension providers about the ethical options currently on offer (whether positively or negatively screened):

- (a) What ethical DC pension funds are available?
- (b) What proportion of people take them up?
- (c) What sort of returns do they provide?

n/a

**QUESTION 5: PENSION SAVER ENGAGEMENT**

(Call for evidence, paragraph 1.18)

We seek views about how far these options (identified in Question 4) meet the needs of savers:

(a) Would a greater range of options encourage greater engagement with pension saving?

(b) In particular, would options seeking social impact as well as financial returns encourage engagement?

Yes:	No:	Other:
n/a		

**QUESTION 6: RETURNS FOR SOCIAL INVESTMENT**

(Call for evidence, paragraph 1.18)

We are also interested to hear about the returns available for social investment (intended to have a positive benefit):

(a) Are there sufficient investment opportunities to provide both social impact and market returns?

(b) How far should savers be prevented or discouraged from sacrificing returns for social impact?

Yes:	No:	Other:
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n/a
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**QUESTION 7: FINANCIAL ADVISORS AND SUITABILITY**

(Call for evidence, paragraph 1.22)

In practical terms, how can financial advisers:

- (a) best explore their clients' social motivations?
- (b) present social investment options in a way that is clear, fair and not misleading?

n/a
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**QUESTION 8: LABELLING SOCIAL INVESTMENT OPTIONS**

(Call for evidence, paragraph 1.23)

Should social investment options be labelled or described in a standardised way? Would this be possible given the range of funds which might be regarded by different groups, or in different contexts, as social investment?

Yes:	No:	Other:
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n/a
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**QUESTION 10: LAW OF SOCIAL ENTERPRISES**

(Call for evidence, paragraph 1.25)

Is there a need to review the legal framework around social enterprises, to make it easier for such enterprises to borrow money and receive investment?

Yes:	No:	Other:
n/a		

**FURTHER COMMENTS:**

We also welcome any additional comments you may have beyond the scope of the questions above, particularly where they relate to the legal or regulatory landscape.

<p>It is observed generally that many, if not all, of the questions posed here appear really to be practical ones aimed at pension providers/trustees/managers and advisors. In other words, it is considered that the issues raised by this call for evidence are not really for us. We can only give an overview of the legal framework/background against which issues of infrastructure / social investment arise (which we have sought to do, but appreciate is largely replicating the work of</p>
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the Law Commission in this field already). What is perhaps more pertinent is to discover why, from the investor's and investee's perspective, pension funds are not investing in infrastructure / social investments, and specifically what it is within the legal and regulatory framework that pension providers/trustees/managers and advisors consider in their experience are actual/potential impediments to investment.