December 2016

Law Commission
Tower, 52 Queen Anne's Gate
Westminster, London SW1H 9AG

15th December 2016

Big Society Capital's response to the Law Commission Call for evidence on pension funds and social investment

Dear Sir, Madam

Big Society Capital are delighted to respond to the Law Commission's call for evidence on DC pensions and social investment. We believe this is extremely timely given the growing interest and momentum in this areas from government, individual savers, and progressive pension platforms and providers.

There is a significant opportunity to unlock the £500 billion of assets expected in DC schemes by 2030 by allowing savers to make financial choices that align with their values as well as saving for retirement.

Government can play a key role in supporting this. Our interpretation of the evidence gathered, including legal advice from Sackers, and input from a number of other stakeholders, concludes that there are some legal, regulatory and structural barriers to DC pension funds making social investments.

Based on this, we have made a number of recommendations where targeted policy change could be highly valuable. Our recommendations fall into four themes:

1. **Transparency, disclosure and consultation** – As a first step, we recommend a legal requirement for DC pension funds to disclose the impact of current investments, and to regularly and meaningfully seek the views of members on whether default and chosen options align with their broader values.
2. **Fiduciary duty** – Changes in legislation to give trustees comfort that social investments are in accordance with their legal duties, including the duty to act in the best financial interests of beneficiaries
3. **Liquidity** – Greater clarity is required to overcome structural barriers around investing in less liquid social investments. We recommend an amendment to members' statutory right to request transfers to provide an option to exclude a small, illiquid portion of a fund that could be channelled into social investments.
4. **Accreditation and labelling** – There is a clear role for legal or regulatory backing for an independent body to accredit and label a social pension fund option.

Given the range of barriers above, to address the current inertia we recommend that government mandate all DC pension schemes to offer a 'social' pension fund option. This would have a truly catalytic impact on the market. These recommendations are laid out in detail in the paper, where we have provided responses to all questions raised in the call. If my colleagues or I can expand on these points, or provide more information, please do not hesitate to contact us. We also welcome comments and feedback from other interested parties.

Yours sincerely,

Camilla Parke, Strategy and Market Development Associate, on Behalf of Big Society Capital

December 2016

Introduction

Big Society Capital is delighted to respond to the Law Commission's Call for Evidence on DC pensions and social investment. Our response has been formed on the basis of reasonable evidence available and our best interpretation of legal advice provided by Sackers, a firm specialising in pension scheme trustees and sponsors. Our response has also been shaped through consultation with a range of stakeholders active in this area including NGOs, think tanks and those working closely with DC pension funds and providers. We welcome comments and input from others on the recommendations outlined.

Our response

Question 1: What are the barriers to pension funds investing: (a) In infrastructure generally? (b) In socially significant infrastructure? (c) In other forms of social investments?

Question 2: Do any of those barriers relate to issues of law and regulation?

Evidence suggests that there are some legal barriers to DC pensions making investments into infrastructure, social infrastructure and social investments. These primarily relate to fiduciary duty and the statutory requirement for members to be able to transfer funds that creates a significant liquidity barrier. There are further regulatory barriers related to liquidity and structural issues that make it more challenging for trustees to invest in assets they are unfamiliar with. However, a number of these barriers can be addressed, and we believe government could play a significant role here to accelerate uptake of social infrastructure and social investment by DC pensions.

Defined Benefit Pension funds have been active investors in infrastructure for some time

Defined Benefit pension schemes have been investing in infrastructure (including transportation, utilities and communications) for many years. Although UK pension funds still invest far less in infrastructure than their counterparts in countries such as Australia and Canada, this is increasing. By 2016, British pension funds had an average of 3.6 per cent of their assets invested in infrastructure, up from 3.2 per cent in 2010[1]. Similarly, social infrastructure (including investment in to schools, hospitals, universities, and prisons) is gaining interest, and government[2] is keen to support higher levels of pension fund investment into these assets, particularly in a low-interest rate environment.

There is also some evidence of more progressive DB pension funds and other institutional investors making social investments, where both investors and users of capital intend to make a positive social impact as well as a financial return. There are a wide range of different forms of social investment, including smaller, more illiquid investments into charities and social enterprises (both directly or through funds), through to larger investment into organisations with a defined social purpose, and investments into public institutions that intend to deliver social impact.

However, to date there are much lower levels of investment into infrastructure and social infrastructure through DC pensions. This is also the case for social investment. The Law Commission has called for evidence on the barriers to DC pension funds making these types of investment. There are some legal barriers to DC pensions engaging in these types of investment. These primarily relate to fiduciary duty and the statutory requirement for members to be able to transfer funds that creates a significant liquidity barrier. There are further regulatory barriers related to liquidity and structural issues that make it more challenging for trustees to invest in assets they are unfamiliar with. We believe this is significant given the growing body of evidence that the Law Commission refers to that suggests that savers are interested in products that allow create social impact and save for retirement.

Both general infrastructure and to a lesser extent, social infrastructure investments have historically been attractive to large DB pension schemes as a way of matching assets with long term pension payment liabilities and as a means of portfolio diversification. Both infrastructure and social infrastructure assets can be listed and unlisted, though a higher proportion of

[1] Data from Preqin, quoted in the Financial Times, https://www.ft.com/content/a05fe960-95ec-11e6-a1dc-bdf38d484582
[2] Insert reference to government support for this

social infrastructure is unlisted, and therefore, less liquid. The large size of many DB schemes and different draw down requirement means they are able to tolerate this balance and to invest in assets with long term time horizons. Examples of significant investments in these areas include:

- **The Stanhope Pension Trust -** made the first investment of its kind by a UK pension fund in 2014 into a major Scottish road project, arranged by Allianze Global Investors, as part of a £175m total investment
- **Legal & General** - have invested £8 billion in UK infrastructure to date, including direct investments and urban regeneration projects, and aims to invest £15 billion in UK infrastructure in total. Aviva and Legal and General are among six insurers that have agreed to collectively invest £25bn in UK infrastructure over the next five years
- **Multi-Strategy Infrastructure Fund (MPIS) -** aiming to invest a minimum of £2bn into UK infrastructure, of which over £1bn is committed through its indirect investment programme, including the Thames Tideway Tunnel, or London 'super sewer'
- **The BT Pension Scheme –** holds a minority equity stake in Thames Water, and shareholdings in Kemble Water Holdings, which are illiquid inflation-linked investments

A number of Defined Benefit pension funds are starting to actively engage with social investment

Investment seen to date by pensions funds in this area has typically been larger-scale social investments that are targeting market rate returns and investments for broader public purpose into organisations intending to deliver social impact. There are broadly three ways pension funds are engaging:

1. **Investments into existing social investment funds** – examples include several pension fund investing into The Cheyne Social Property Impact Fund[3]. The fund's objective is to invest £900 million to increase the capacity of charities and social enterprises that deliver services such as supported housing for people with disabilities, affordable housing for those on low incomes, elderly care and specialised housing for people experiencing homelessness.
2. **Partnerships to identify and assess social investment options** – for example, to realise large-scale community investment opportunities, the £250m Investing4Growth[4] fund was started by five Local Authority Pension Funds working in collaboration to make investments that provide a commercial return and also have a beneficial economic, social or environmental impact. Investments included the Bridges Ventures Social Impact Bond fund.
3. **Setting up new social investment funds** – Greater Manchester Pension fund allocated £150m into an Impact Portfolio (as a follow on from its involvement in Investing4Growth as above), a portion of which was allocated to social investments such as provision of affordable housing.

A number of barriers exist that are preventing DC pension funds from investing in infrastructure and social investment assets

Compared with the activity seen to date through DB funds, investment in infrastructure (including social infrastructure) and social investments are not happening at the same scale through DC funds. This is signification given the UK's shift from a largely DB to DC pensions market. There are three types of barriers limiting activity in this areas: legal, regulatory and structural. These are summarised in Table 1 below, and are our best interpretation based on independent legal advice from Sackers (see Appendix 1). A full version of this advice can be found on Big Society Capital's website and is available in request. Given the diversity of assets involved, Table 2 outlines our interpretation of how these barriers may impact different forms of infrastructure, social infrastructure and social investments.

[3] More information available at https://www.bigsocietycapital.com/what-we-do/investor/investments/cheyne-social-property-impact-fund
[4] More information available at http://pirc.co.uk/I4G/files/June2014-Concluding-Statment.pdf

Table 1: Barriers to DC pension funds investing into infrastructure, social infrastructure and social investments

<table>
<tr><th></th><th colspan="2">TRUST BASED DC</th><th colspan="2">CONTRACT BASED DC</th></tr>
<tr><th></th><th>Default fund</th><th>Chosen fund</th><th>Default fund</th><th>Chosen fund</th></tr>
<tr><td colspan="5">LEGAL</td></tr>
<tr><td>Fiduciary Duty</td><td>Assessment of an investment should be based on consideration as to how its inclusion will service the best financial interest of members.

In practice, this means Trustees must not consider non-financial factors that do not serve these interests even if members share this viewpoint (reference to the Law Commission’s ‘Two tests)

The materiality threshold on the risk of significant ‘financial detriment’ is very low.

Trustees are interpreting this in practice as the risk of any financial detriment, rather than, as the Law Commission suggests risk of ‘significant’ financial detriment. This means trustees are highly unlikely to consider non-financial factors at all, even if there is clear member interest and materially very low or no risk of financial detriment.</td><td>It is fully compatible with a trustee’s fiduciary duty to offer a chosen fund that takes into account non-financial factors.

This can include investments into infrastructure, social infrastructure and social investments (those that intentionally target social objectives)

This can include investments that come with the risk of lower than market rate financial return (though inclusion of the above doesn’t necessarily mean lower return) - as long as these risks are communicated to members.

There remains a fiduciary duty to monitor all investments offered and ensure they remain appropriate to members’ needs. This may present a perceived structural barriers due to unfamiliarity with social infrastructure and social investment assets</td><td>Independent Governance Committees (IGCs), employers and providers each owe a duty of care to members. Issues of fiduciary-like duties apply similarly as they do to trustees, outlined in the left column.

In practice, it will be very challenging for any parties involved to select a default fund based on criteria that are not in the best financial interests of members, i.e., if there is any real or perceived risk of financial detriment

As described with regard to trust-based default funds (left), parties are interpreting this in practice as the risk of any financial detriment, rather than, as the Law Commission suggests risk of ‘significant’ financial detriment. This means parties are highly unlikely to consider non-financial factors at all, even if there is clear member interest</td><td>Fiduciary duty is less likely to be a barrier here

Again, as with trust-based schemes it is perfectly appropriate for members to be offered funds that specifically take non – financial factors into account, even if there is a risk of financial detriment.

There remains a duty to communicate this appropriately to members and monitor all investments offered. This may present a perceived structural barriers due to unfamiliarity with social infrastructure and social investment assets</td></tr>
<tr><td colspan="5">REGULATORY</td></tr>
<tr><td>Permitted Links</td><td colspan="4">This applies to all DC pension fund options offered through an insurance platform. FCA regulation requires that insurers must be able to track the value of a policy by tracking the underlying funds selected by a member. The value of a member’s units is derived from assets which are structured as “permitted links”, which in practice means those that are ‘readily realisable’.[5]
Hence, any funds that include infrastructure, social infrastructure or social investments must be structured as “permitted links” to be offered on an insurance platform. These funds may include within their portfolio third party managed funds which are not on their own “permitted links”, as long as the overall fund is structured as a “permitted link”. This is a complex area of FCA regulation that warrants further clarification in the context of social investments.</td></tr>
<tr><td colspan="5">STRUCTURAL</td></tr>
<tr><td>Liquidity</td><td colspan="4">There is no explicit regulatory requirement to offer only highly liquid funds in DC pension schemes and in theory, a very illiquid fund should not be inconceivable for a pension scheme saver under normal circumstances.

However, members statutory rights to transfer benefits when they cease pensionable service with a particular employer (Pension Schemes Act 1993) is a significant barrier to pension funds in holding more illiquid assets.

A further regulatory barrier is the requirement for platform providers to redeem individuals’ underlying linked investments to meet liabilities that may arise.</td></tr>
</table>

[5] See the FCA COBS Sourcebook, Chapter 21 for more: https://www.handbook.fca.org.uk/handbook/COBS/21.pdf

Inertia	Trustees must consider "proper advice" as to whether an investment is satisfactory under the requirements of the Occupational Pension Schemes (Investment) Regulation 2005. Most trustees will be select pooled funds to which this advice applies. Whilst the need for advice is not itself a regulatory barriers, in practice, most trustees will select established investments which their advisors are familiar with that do not require additional due diligence. This may, therefore, be a perceived barrier with regard to funds that incorporate social infrastructure or social investment assets.
Governance & monitoring	As above, Trustee fiduciary duties include regularly reviewing and monitor the performance of funds. Funds with more 'diverse' objectives, which could include those that may also target social objectives, could be perceived as requiring additional monitoring requirements. This is likely to add an additional cost burden.
Member communications	There is an obligation on Trustees and contract based providers to ensure that fund descriptions provide a sufficient description of the nature and risk of funds on offer so members can make informed decisions. Due to a lack of familiarity with particular social infrastructure or social investments, there may be a perceived barrier in relation to communicating the nature of these funds to members

Table 2: Implications for listed and unlisted infrastructure, social infrastructure and social investment assets

	Infrastructure investments	Social infrastructure investments	Social investments
LEGAL			
Fiduciary Duty	No legal barriers to infrastructure investments provided that inclusion does not present risk of financial detriment (in default fund).	No legal barriers to social infrastructure investments provided that inclusion does not present risk of financial detriment (in default fund). Lack of familiarity with these assets may mean trustees are unwilling to include even when material risk of detriment is negligible.	No legal barriers to social investments provided that inclusion does not present risk of financial detriment (in default fund). In practice, this is a significant barriers to the making social investments, even those that target market rate returns.
REGULATORY			
Permitted Links	Underlying assets must be structured as "permitted links" – realisable in the short term. Hence, less of a barriers for listed infrastructure investments. Unlisted investments can be accessed through a "fund of fund" structure if the collective investment itself were structured as a "permitted link"	Underlying assets must be structured as "permitted links" - realisable in the short term. In practice, this is challenging for illiquid, unlisted social infrastructure investments. Investment into these assets would be possible through a "fund of funds" structure if the collective investment scheme itself were structured as a "permitted link"	Underlying assets must be structured as "permitted links" – realisable in the short term. In practice, this is challenging for illiquid, unlisted social investments. Investment into these assets would be possible through a "fund of funds" structure if the collective investment scheme itself were structured as a "permitted link".
STRUCTURAL			
Liquidity	Infrastructure investments can be both listed and unlisted. Infrastructure investments that are illiquid (it is not uncommon for an infrastructure limited partnership to have a 10 or 15 year term during which it cannot be redeemed) can be highly problematic for DC pension funds. However, this is a structural barrier than can be overcome through appropriate design of a fund, for example, if overall liquidity can be provided by a majority of a fund that includes a small proportion of illiquid assets.	Social infrastructure investments tend to be unlisted and therefore less liquid. Structural barriers related to the liquidity of underlying investments in products listed on DC platform is an issue. However, illiquid assets can be invested into indirectly through collective investment schemes that bundles these assets with liquid ones. A significant barrier is the statutory requirement for members to be able to transfer funds.	Some social investment assets (social property, listed charity bonds) are liquid. Other are less liquid, for example, direct investments into charities and social enterprises. Structural barriers related to the liquidity of underlying investments in products listed on DC platform is an issue. However, illiquid assets can be invested into indirectly through collective investment schemes that bundles these assets with liquid ones. A significant barrier is the statutory requirement for members to be able to transfer funds.

	A significant barrier is the statutory requirement for members to be able to transfer funds.		
Inertia	As listed infrastructure investments are likely to be more familiar to trustees, providers and investment managers, less likely to be a barrier	In practice, social infrastructure investment assets (particularly the smaller, less liquid types) are less familiar to trustees, providers and investment managers.	In practice, social investment assets (particularly the smaller, less liquid types) are less familiar to trustees, providers and investment managers.
Governance & monitoring	As listed infrastructure investments are likely to be more familiar to trustees, likely to be less concerns around additional monitoring requirements	As above, this may lead to real and perceived barriers around additional monitoring and diligence requirements. For smaller funds, the possibility of additional costs associated with diligence and monitoring may be a barrier.	As above, this may lead to real and perceived barriers around additional monitoring and diligence requirements. For smaller funds, the possibility of additional costs associated with diligence and monitoring may be a barrier.
Communications	As above, unlikely to be a significant barrier	As above, trustees and providers may require more support to effectively communicate the nature and risk (where relevant) of funds that include social infrastructure investments. A lack of familiarity with impact measurement and reporting may also be a barrier.	As above, trustees and providers may require more support to effectively communicate the nature and risk (where relevant) of funds that include social investments. A lack of familiarity with impact measurement and reporting may also be a barrier.

Government could play a role in addressing a number of these barriers to support the development and uptake of a social pension for DC funds in the UK

Government has expressed interest in enabling DC pensions to make social investments in the UK. A potential structure that has been put forward by Big Society Capital is replicating the '90/10' solidarity employee savings schemes in France within the UK pensions context. This option is described in detail in the paper *Designing a Social Pension Investment Fund for UK pensions*, but could practically involve 90% of a fund investing in listed assets that meet ESG criteria and up to 10% investing in social investments, which could be a mix of larger liquid social investments into public purpose assets (such as social infrastructure) that target market rate returns, and more illiquid smaller scale social investments (such as indirect investments into charities and social enterprises).

Based on the analysis above, we would suggest that under the current legal and regulatory regime, it would be practically very challenging for either trust or contract based schemes to offer such as proposition through a default fund, even if there was compelling evidence to demonstrate member demand for such a product (referencing the Law Commission's 'Two tests' that must be satisfied for non-financial factors to be taken into account by trustees). In practice, trustee interpretation of the law means there it be very challenging for non-financial factors to be taken into account when choosing default fund investments, as trustees are unwilling to risk the potential for any financial detriment to the fund. In the case of social investments, though there are a significant volume of assets that, we believe, would not pose the risk of financial detriment, in practice, unfamiliarity with these assets combined with personal liability means trustees are unlikely to consider proposition that includes social investments.

There would appear to be fewer legal barriers to such an option being offered as a chosen fund, though structural barriers remain.

We would therefore make the following recommendations to government to support the development and uptake of such a fund in the UK:

Problem	Recommendation
Fiduciary duty with regard to default fund In practice, it is very hard for trustees to take into account non-financial factors even if there is clear evidence of member interest, if there is *any* degree at all of possible risk of financial detriment. This could prevent trustees from choosing a default option where a small proportion of the fund was invested into social investments, even if these targeted market rate returns.	1. Changes in legislation to give trustees and ICGs comfort that social infrastructure and social investments are in accordance with their legal duties, including the duty to act in the best financial interests of beneficiaries 2. Clarify through legislation or statutory guidance how Trustees may interpret the risk of 'significant financial detriment'.
Chosen funds There appear to be no legal barriers to chosen funds being offered where a portion of the fund could be placed in social investments, regardless of whether this involves the risk of financial detriment to the member (as long as the natural of the fund is properly communicated and suitability monitored) Indeed, there is a degree of risk to trustees if they do not provide chosen funds that reflect the views and needs of members. Yet, chosen funds of this nature are currently unavailable in the market when evidence suggests there is consumer interest in these propositions.	3. Requirement in law for DC pension funds to disclose the impact of underlying investments to The Pensions Regulator 4. Requirement in law for trustees to regularly and meaningfully seek the views of members with regard to how funds are invested 5. Terms of Reference for Independent Governance Committees should be broadened and clarified by the FCA to require the consultation of members, and that ICGs hold Boards to account for this 6. Requirement for member representation on governance Boards
Liquidity barriers The requirement for member to be able to quickly transfer funds is a significantly liquidly barrier to funds investing in illiquid assets Further, regulation around permitted links in the context of social investment are unclear and given there is no legal requirement for DC funds to only invest in liquid assets, more could be done to enable funds to be structured to incorporate illiquid assets.	7. Amend statutory regulation to include the provision for individual to 'opt in' to accept lower liquidity on a portion of their fund to achieve social aims 8. Clarity around the application of FCA regulation on "permitted links" in the context of DC pension funds making a range of different social investments. This may include the permission for a small proportion of a social pension fund to be invested in illiquid social investments, provided that the remainder of the fund can provide adequate liquidity. 9. Consider ways to encourage the provision of liquidity through third parties for potentially small portions of funds invested in illiquid assets
Inertia Continued inertia driven by a trustee and investment managers lack of comfort with social infrastructure and social investment, compounded by regulatory and structural barriers above	10. Requirement in law for all DC pension schemes to offer a 'social' pension fund option

It is worth noting that in the case of '90/10' solidarity employee savings schemes in France, a number of structural approaches have helped addressed the liquidly challenge of a small proportion of funds being invested into illiquid solidarity enterprises. Firstly, the French Financial Markets Association (AMF) that regulates all financial products, recommends that asset management companies have contracts in place with third parties (banks or stockbrokers) to guarantee the liquidity of unlisted securities. For example, Ecofi Investissements has such a contract with the Credit Cooperatif for its solidarity investments.

Secondly, as the number of assets under management in these '90/10' funds has increased, asset managers have moved towards centralising all solidarity investment into single financing vehicles, the composition of which is regulated by the AMF. These funds must have a minimum of 35% of assets in solidarity companies and a minimum of 30% in listed monetary assets. This scheme allows better liquidity management of the more illiquid solidarity based securities.

Question 3: Is the size of funds a major issue? If so, are there legal obstacles to scheme mergers?

Aside from very small schemes (where certain regulatory requirements do not apply), it appears that scheme size of itself does not creates any material difference in fiduciary or regulatory barriers to investment in infrastructure, socially significant infrastructure or other forms of social investments.

However, larger trust-based scheme with significant assets in the default fund may be better placed to tolerate some illiquidity in relation to a small proportion of its assets and still be able to maintain liquidity at an overall fund level sufficient to satisfy member transfer requests promptly. Similarly larger schemes are likely to have trustee boards capable of devoting greater time and expense overcoming inertial and governance issues which may be disproportionate for a smaller scheme. Indeed, research by Share Action suggests that the size of a pension scheme is a strong indicator of good outcomes for beneficiaries. Schemes must operate at scale to ensure adequately skilled governing bodies, sufficient internal support and to access economies of scale and better bargaining power.[6]

Problem	Recommendation
The process of scheme mergers itself has been identified as difficult	11. Consider how scheme mergers could be simplified. If there is interest in accelerating uptake of social investment through DC schemes, consider whether this could be incentivised by simplifying merger processes for those funds offering a social pension option

Question 4. 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?

Publically available information on uptake and the returns of 'ethical' funds is limited which makes it challenging to assess the current landscape of market provision. Given the importance of this, we could recommend that The Pensions Regulator formally requests the employers and providers supply information on the range of 'ethical' options available, their targeted returns, up take and member engagement.

There are a growing number of 'ethical' pension funds on offer. However, what is described as and constitutes an 'ethical' fund varies widely. Three broad groups of 'ethical' investment strategies are outlined below and evidence suggests that these funds can outperform those that do not employ these strategies.

While there are (helpfully) a growing number of pension fund options that integrate environmental, social and governance (ESG) criteria to enhance value, there are no options currently available that direct a portion of the fund to intentionally create positive social impact. As identified by the Law Commission, there is a growing body of evidence to suggest that individuals are interested in pension propositions that not only screen out certain investments, but that positively target the positive social outcomes. We believe this represents a significant gap, where savers are not currently being provided with choices to meet this expressed need.

Current options available adopt a number of Socially Responsible Investment (SRI) strategies

[6] http://shareaction.org/wp-content/uploads/2016/01/ReducingRegulationReport.pdf

What is often called an 'ethical' fund in the market is a one that adopts some form of SRI strategy. According to Eurosif, the UK is Europe's largest SRI market with a total of £10.2bn now being managed in this kind of product in the UK.[7]

Sustainable and Responsible Investment (SRI) incorporates any strategy an investor may deploy which incorporates Environmental, Social and Governance (ESG) consideration or analysis. These ESG issues may be incorporated in a variety of ways, and for simplicity, these can be grouped into broadly three buckets, outlined below. It is important to note that funds available in the market tend to adopt a mix of investment strategies across these:

- **Exclusions and norms-based screening** – those that exclude specific investments or classes of investment from the investible universe such as companies, sectors or countries, which may be based on moral or ethical criteria, or that do not comply with international standards and norms. One could also include emerging approaches such as Sharia pension funds[8] within this group, as these funds will only invest in companies confirmed as being Sharia compliant and this typically involves the exclusion of certain industries and companies.
- **ESG integration and 'best in class' approaches** – those that incorporate social, environmental and governance risks (ESG) into their investment decisions to help to protect value. 'Best in class' funds deeply integrated ESG factors into their investment analysis and proactively select companies that they believe will outperform the market because they operate (or have the potential to operate) in a more sustainable way than their peers over time
- **'Low carbon' or environmental approaches**- also known as 'sustainability themed' investments including 'low carbon' funds.

The range of approaches that can be taken by 'ethical' funds highlights the necessity for clear, transparent and accessible information to be presented to savers to allow them to make informed choices. An example of good practice is NEST which offers an 'Ethical' investment fund. The information provided to potential savers clearly defines the investment approach, including the material difference in the way in which the fund interprets the terms 'ethical' and 'responsible' investment, and how this defines the investment strategy in practice[9].

Publically available information on uptake and the returns of 'ethical' funds is limited. However, evidence suggests that funds that integrate ESG criteria outperform those that do not. In the UK, the Environment Agency DB Pension Fund that has taken a rigorous approach to ESG integration, and proactively invested into areas such as sustainability property and social infrastructure and out-performed its benchmarked by an average of 8.9% over the past 3 years.[10] Internationally, Sustainable pension funds on offer within Sweden's Premium Pension System (PPM) have had both higher returns and lower fees on average in the last five years than other funds[11.] The average return for M/E-labelled funds (funds that take environmental and/or ethical considerations) in the last five years is 5.5% compared with 4.1% for other funds.

In terms of uptake, we have heard anecdotally that the uptake of NEST's 'Ethical' Fund is low. There are likely to be a number of reasons for this, including low levels of engagement overall with options outside of the default fund which is a broader consideration. There also appears to be a lack of awareness of options amongst savers: a Good Money Week poll found that 54% of the GB public is unaware that sustainable and ethical financial products exist, rising to over 63% among millennials (18-34 year olds).

Problem	Recommendation
Publically available information on uptake and the returns of 'ethical' funds is limited	12. The Pensions Regulator formally requests the employers and providers supply information on the range of 'ethical' options available, their targeted returns, up take and member engagement.

[7] https://www.trustnet.com/News/616147/fe-research-the-ethical-funds-that-advisers-should-be-looking-at
[8] Examples of Sharia Funds include NEST Sharia Fund that invests in larger global companies that comply with Sharia principles. Vodafone offer employees a DC Sharia Fund that invests in the HSBC Life Amanah Pensions Fund.
[9] For more on the NEST ethical fund, see https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/NEST-ethical-fund-brochure.pdf
[10] https://www.theguardian.com/sustainable-business/environment-agency-pension-fund-responsible-investment
[11] https://www.ipe.com/news/esg/sustainable-funds-outperform-with-lower-fees-says-swedish-pensions-agency/10015309.fullarticle

There remains a gap in the market for a 'social' pension option that intentionally targets the creation of positive social impact

As above, we are not aware of any existing DC pension products available in the market that allow savers to make social investments whilst also saving for retirement.

There is, however, evidence of interest in such a product. Research by the Defined Contribution Investment Forum[12] found that 77% of individuals favoured a social pension fund over a conventional fund if the returns were similar; 44% still preferred the social fund, even when they were told that they would receive an 8% smaller pot, and 30% agreed even if the pot was 18% lower.

Question 5: Would a greater range of options encourage greater engagement with pension saving? In particular, would options seeking social impact as well as financial returns encourage engagement?

In principle, we believe it is important for savers to have access to choices that meet their needs and the capacity and information to make an informed choice that is right for them. Whilst there are a range of 'ethical' options available to savers, there are currently no products that allow savers to make social investments that generate positive social impact and income in retirement. In this sense, we do not feel savers currently have access to the right options to meet their expressed desired. We believe that savers are more likely to engage with choices they feel reflect their broader values.

The extension of pension flexibilities means savers in the UK have greater choice over how to access their pension than ever before and the shift from DB to DC schemes and auto-enrolment places much greater onus on the individual to engage with these choices. Though there are currently no such pensions options available to savers, there is evidence from parallel markets to suggest consumers engage more (and practically pay more) for choices that create social impact. It is therefore not unreasonable to assume that a social pension option could encourage broader engagement with savings.

There is some international evidence that over time greater focus on individual choice can support higher engagement

There is some international evidence that over time as savers have greater choice and agency over their pensions options their engagement with their pension increases. Across countries, general levels of saver engagement with their pensions is low, but Australia is a notable exception. The Australian DC system is characterised by high levels of flexibility for savers, and has been for the past 20 years, unlike in the UK where flexibility is reasonably new. It has been suggested that one of the factors contributing to this engagement is that Australian employees typically choose their own pension provider, which creates significant focus on individual choice. Further, evidence both from Australia and the UK is that as members' pot size increases, the engagement levels also grow.[13] Though it is challenging to compare the UK with other international models based on very different contexts and cultural attitudes towards savings, there does appear to be evidence that over time in pensions markets where there is greater onus on the individual, this may lead to higher levels of engagement.

Consumer behaviour in parallel markets suggests socially motivated behaviours can be self-reinforcing

Currently in the UK, there are no options for DC pension savers to positively target the creation of social impact whilst also delivering an income in retirement, which means there is no direct evidence that such an option would increase engagement. There are, however, three areas of evidence that point to how this may link to broader pension engagement:

- Evidence from Share Action indicates that greater transparency around where pensions are invested can increase member engagement[14]

[12] Defined Contribution Investment Forum, Identifying new ways to engage with savers in defined contribution pensions (March 2013)
[13] DCIF Engagement Barometer 2016, see http://www.dcif.co.uk/resources/
[14] Governance and administration of occupational defined contribution trust based schemes, response prepared by Share Action, Jan 2016. Accessed here: https://shareaction.org/wp-content/uploads/2016/04/CR-1.pdf

- Anecdotal evidence from Canadian pension funds indicates that those that actively communicate their ESG stance to members have higher engagement levels[15]
- Wider consumer evidence from parallel markets that suggests consumers are willing to change their buying behaviour to make positive choices that reflect their values. Data from Nielsen shows that almost two-thirds (66%) of consumers are willing to pay extra for products and services that come from companies who are committed to positive social and environmental impact.[16] Similarly, research from the US has shown that consumers are pay more at the point of purchase for Fairtrade products because they align with their values[17].

Based on these proxies, it is not unreasonable to think that financial options (including savings and pensions) that align with individuals broader values could prompt them save more.

Question 6: 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?**

Yes, based on our analysis of the social investment market in the UK, we believe there are at least £67.4bn of social investment assets suitable for pension fund investment that are targeting market rate or close to market rate of return and delivering social impact.

Big Society Capital's recent paper 'Designing a social investment fund for UK pensions' explores the current universe of social investment assets that could be suitable for investment through pension funds. As referenced in this paper when considering the potentially investable universe, it is important to draw the distinction between 'Socially Responsible Investment[18]' assets and those that can be considered 'high impact' assets that generate positive social impact. Within this are social investments – where both investors and users of capital intend to make a positive social impact. SRI investments tend to be in listed companies, whereas social investment covers a range from smaller-scale, less liquid investment to larger scale listed investments.

The table below outlines different social investment assets in the UK that are targeting or achieving close to or market rate returns that could be suitable for pension fund investment.

1. 'Established' investments achieving market rate returns Relatively more 'established' social investments and investments into large social assets that have demonstrated track record of targeting and achieving market rate or close to market rate returns, examples include:		
A sset type	**Market size (stock, mn)[19]**	**Typical targeted rate of return**
Housing Association bonds (some listed) and secured commercial loans Raising long term capital for the development and maintenance of social housing	£59bn	Typically 1.5-2.5% higher than inflation linked gilts, zero-default record
Charity Bonds (listed and unlisted) Charities financing investment needs through the issue of bonds, larger-scale listed bonds (>£10m) can be issues to retail investors	Charity bonds (listed and unlisted) total: £6.5bn, of which £6.4bn are large listed Charity Bonds	Listed retail charity bonds typical range 4 – 4.5% coupon Example of an unlisted bond, Golden Lane Housing £10m issue of unlisted 5 year bond at 4%
2. Emerging investments targeting market rate returns		

[15] Based on conversations with UN PRI around the experience of signatories
[16] http://www.marketingcharts.com/traditional/will-consumers-pay-more-for-products-from-socially-responsible-companies-60166/
[17] https://www.gsb.stanford.edu/insights/jens-hainmueller-will-consumers-actually-pay-fair-trade
[18] The Principles of Responsible Investment defines 'responsible investment' as "an approach to investment that explicitly acknowledges the relevance to the investor of environmental, social and governance factors, and of the long-term health and stability of the market as a whole. It recognises that the generation of long-term sustainable returns is dependent on stable, well-functioning and well governed social, environmental and economic systems."
[19] The size and composition of social investment in the UK, Big Society Capital, available here: https://www.bigsocietycapital.com/sites/default/files/attachments/The%20size%20of%20and%20composition%20of%20social%20investment%20in%20the%20the%20UK_3.pdf

Investments still establishing track record, but are targeting close to market rate returns, examples include:		
Equity like-lending Small and medium sized charities and social enterprises taking on 'quasi-equity' growth capital	£32m	Information not publically available but will be targeting close to market rate
Green bonds Bonds issued by large companies where proceeds are used for environmental purposes	£1.6bn	Average yield 1.5 – 2% (for a 5.5 year bond with AA rating)[20]
3. Higher risk investments targeting close to market rate returns Currently accounting for approximately half of Big Society Capital's current investment portfolio. These assets tend to have a higher financial risk profile and as yet, limited track record of return		
Social Impact Bonds Payment by results models that enable social organisations to deliver an innovative social service for the public sector.	£14m	Target range 5 – 15% By example, The £25m Bridges SIB fund targeted a return of 5% a year.[21]
Social property Investment made to finance the purchase and operation of properties that service the social sector and local authorities, often providing affordable housing and/or housing for those with specific needs.	£130m	Target net return: Levered funds 10-12% Unlevered funds 5 – 7%
SME charity debt Small and medium sized charities and social enterprises, unsecured loan finance	£158m	Target net return: Secured – 3 – 6% Unsecured – 8 – 10%

There are also a range of investments into assets through public institutions targeting close to or market rate returns, that may not be considered to be social investment as defined above, but are serving a broader public purpose. These include:

- Local Authority Bonds (£850m)
- Quasi- government bonds (£8.5bn)
- Social infrastructure (£57.7bn)

Based on the above, we can estimate that there are approximately **£67.4bn** of social investment assets suitable for pension fund investment that are targeting marker rate or close to market rate of return and delivering social impact. This is significantly higher if the three buckets above are also included. We believe this is sufficient to support the setup of new funds, however in the longer-term, a deeper pool of investable assets will be needed

b) <u>How far should savers be prevented or discouraged from sacrificing returns for social impact?</u>

Based on the information provided above, it is important to note that making social investments does not necessarily require financial returns to be sacrificed. As described above, there are a range of social investments that are targeting market rate returns, some of which are likely to be more appealing to institutional investors including pension funds. Similarly, there are social investments, particularly more illiquid, riskier smaller-scale investments into charities and social enterprises that may not target or deliver market rate returns.

In practice, there is evidence that there are savers and investors who are prepared to accept a lower than market rate financial return to make an investment that aligns with their broader values. In the UK, the largest ever survey of those currently holding 'positive' savings or investments indicates that 48% would be prepared to achieve lower financial returns in order to achieve a 'positive' investment objective, rising to 64% of those under the age of 30[22]. This is significant when considered that 75% of this group overall say more than half of their wealth is currently held in 'positive' savings and investment. Similarly, evidence from Barclays[23] suggests that there are a portion of individuals for whom giving up a degree

[20] Green & Sustainable bonds: growth with staying power?" Natixis, 01/12/14.
[21] http://www.thirdsector.co.uk/social-impact-bond-fund-give-returns-5-year-says-antony-ross-bridges-ventures/finance/article/1311812
[22] Research conducted by Ethex no behalf of the Social Investment Research Council. Sample size 2001 individuals, 2016.
[23] https://wealth.barclays.com/content/dam/bwpublic/global/documents/wealth_management/wp-a-behavioural-framework-for-impact-investing-and-philanthropy.pdf

of financial return to create social impact is in itself intrinsically motivating, and the idea that 'social good is costless' may actually remove their motivation for engaging in this behaviour.

The motivations of individual saves and investors are clearly highly complex, and we are still relatively early in our understanding of these motivations. For example 70% of individual currently using their money this way say that savings or investing positively is part of their overall commitment to living responsibly, whereas 25% are motivated by their religious beliefs. The important point is that individuals should have the opportunity to choose whether or not to sacrifice financial return for social impact if this aligns with their values and is the right choice for them.

In order to realise this, individuals must first have access to the products that allow them to align their financial choices with their values, and secondly to information that is 'clear, fair and not misleading', as required by the FCA, to make informed choices.

Question 7:

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?**

Currently, suitability is often understood and interpreted by financial advisers and managers in purely financial terms. This leads to poor outcomes for consumers and the misallocation of capital[24]. To properly understand a client's financial situation and investment objectives, it is necessary for advisers and managers to understand a range of non-financial factors, including: (a) whether the relevant client wishes to screen out investments which might have a negative social and/or environmental impact; (b) whether the client wants investments with a positive social and environmental impact; and (c) the relative importance of social and environmental impact as against other traditional financial factors, including return, risk and liquidity.[25]

A recent FCA consultation on regulatory barriers to social investment concluded, based on the responses from a number of financial planning firms and advisors, that there were no regulatory barriers to advising clients on social investments. However, it is clear that those firms who do advise clients on social investment believe this requires a different conversation exploring client's motivation as well as their financial needs. For evidence of how this is being achieved in practice, we would highlight the extensive efforts made by Worthstone, the leading independent social impact investment resource for financial advisers, to support and empower advisors to advice clients on social investment where suitable.

Worthstone regularly convene financial advisors and wealth managers with policy makers and regulators to explore barriers, emerging issues and share best practice[26]. Worthstone have made great strides here, including the launch of an accredited Adviser Competency Training for social investment that received the support of the Minister for Civil Society, Rob Wilson, at its launch at the Social Investment Academy in March 2016[27]. Examples of high level syllabus topics can be found in Appendix 2.

A number of case studies provided on the Worthstone website outline the practical approach taken by a Financial Advisor to understand their clients social motivations and when suitable advise them on a social investment. A persistent barrier for financial advisors is the possibility of complaints to the Financial Ombudsman Service relating to social impact concerns and this remains an area of concern. However, we welcome the recommendation outlines in the FCA's response to the consultation to work with the Financial Ombudman Service to carry out a communications programme targeted at social investment stakeholders, explaining how the Financial Ombudsman Service's rules apply in this particular contest.

[24] http://www.bwbllp.com/file/fca-call-for-input-submission-of-bates-wells-and-braithwaite-london-llp-14-3-16-pdf
[25] http://www.bwbllp.com/file/fca-call-for-input-submission-of-bates-wells-and-braithwaite-london-llp-14-3-16-pdf
[26] Reference to the Worthstone Social Investment Academy
[27] http://www.worthstone.co.uk/news-thoughts/government-announces-fca-accredited-social-investment-training-initiative-for-advisers/

For additional context on this area, we would highlight Law Commission to the following reports:

- Research published by Worthstone into the barriers which prevent investment advisors from recommending social investments, 'Financial planners as catalysts for social investment', published by NESTA.[28]
- The findings of an expert working group 'Advising clients on social investments and deciding on suitability', a report published by Worthstone, in partnership with Big Society Capital and BWB[29]
- The FCA's Call for Input: Regulatory Barriers to Social Investments, sections 2.20 – 2.38, pp 10 -13.[30]

Question 8. 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. In principle, our view is that the independent accreditation and labelling of social investment options that intentionally set out to generate social impact alongside financial return, if structured and governed appropriately, could bring three benefits to the market; specifically:

- **increasing the confidence of investors that the choice they are making is transparent and that their savings or investments are channelled into genuine social investments**
- **supporting and encouraging the development of best practice with regard to the provision of social investment options**
- **providing a degree of consistency and certainty for the regulator (as well as for investors)**

A number of voluntary codes already exist to increase the accountability and transparency of Socially Responsible Investment (SRI) options. These include the UN PRI code with more than 1600 asset manager, investment manager and service provider signatories, and the Eurosif Transparency Code that has been made a mandatory requirement by a number of national SRI labels in Europe, and currently covers more than 500 funds and 50 signatories[31].

We believe there is demand from a range of stakeholder for a labelling or accreditation approach that applies to social investments:

- **Individual savers and investors**: A survey of 2,000 UK investors showed overwhelming support for the introduction of a Kitemark-style label to help them identify which financial products operate in a sustainable or ethical way. In total, 63% of the UK public supported the proposition and 43% said it would make them more likely to buy a financial product, rising to 53% of 18- to 24-year-olds[32]. Survey data from employees saving into the solidarity saving schemes in France suggested that the guarantee of the social use of funds provided by the Finansol label is one of the top two reasons for employees saving through these vehicles.
- **Government:** To provide clarity and transparency in this relatively new form of investment and trust
- **Mainstream financial institutions**: Aviva CEO Mark Wilson recently publically called for 'establishing a Responsible Investment Standard' – a "Fairtrade for Finance"[33] so that fund managers can demonstrate their credentials as responsible investors
- **Social investment intermediaries**: Triodos Bank has publically welcomed the introduction of a kite mark-style scheme to help people easily invest their money in ways that are "good for people and the planet" and have called for all major players in the UK financial system to work together to make this happen.[34]

[28] 'Financial planners as catalysts for social investment' by Anthony Elliott, Gavin Francis and Geoff Knott, NESTA, 2012
[29] http://www.worthstone.co.uk/adviserarea/assets/pdfs/Advising_clients_on_social_investment_-_deciding_on_suitability.pdf
[30] https://www.fca.org.uk/publication/feedback/fs16-11.pdf
[31] https://www.eurosif.org/transparency-code/
[32] Good Money Week poll, http://blueandgreentomorrow.com/news/public-call-financial-kitemark-help-identify-sustainable-financial-products/
[33] http://www.aviva.com/media/thought-leadership/money-talks-how-finance-can-further-sustainable-development-goal/
[34] Quoted here: http://blueandgreentomorrow.com/news/public-call-financial-kitemark-help-identify-sustainable-financial-products/

There is also the argument that give the relatively nascent stage of the social investment market, there is value in the development of an accredited label to build investor confidence and support the development of best practice.

The solidarity savings scheme in France provides a strong model for a successful accreditation and labelling approach

This system has three component parts:

Accreditation of solidarity organisations	Accreditation of 'solidarity' employee savings funds	Finansol labelling of accredited funds
Issued by prefectures (local government administrative units) and based on the definition of a solidarity enterprise as laid out in the Social and solidarity based economy Act 2014)	Issued by the French Financial Market Regulator, that regulates, authorises and monitors all financial products	Issued by Finansol, an independent 12-member committee, on the dual basis of transparency and the percentage invested in solidarity organisations

Figure 2: Accreditation and labelling of solidarity funds in France

The French approach to accreditation and labelling provides a good lens through which to consider how a similar system might work for the social investment options in the UK.

Below, we consider the different possibilities for where accreditation and or/ labelling could be applied, with example of other frameworks that adopt these approaches.

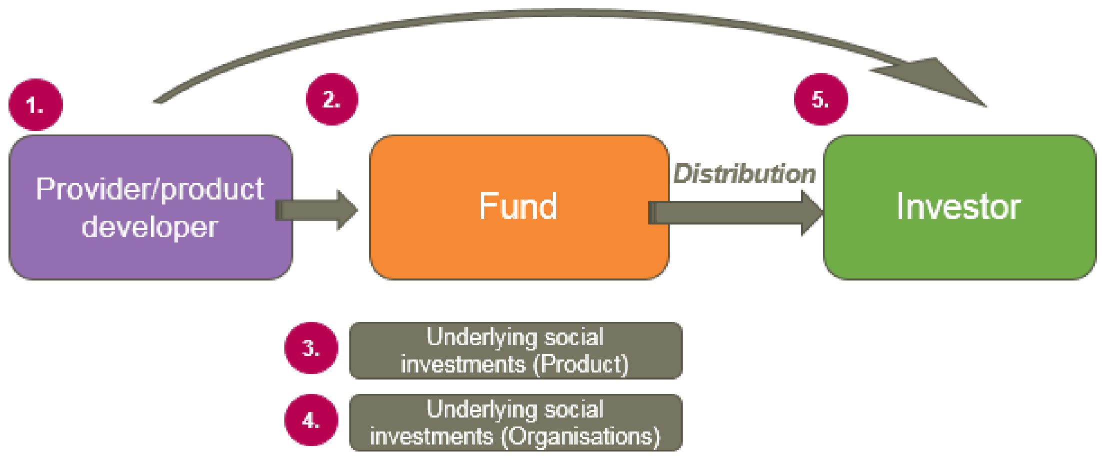

Figure 3: Options for social investment accreditation in the UK

OPTION		EXISTING EXAMPLES	ASSESMENT
1.	**Provider/ product developer**	**Finansol label** in France labels solidarity saving and investment products or funds. However, award of the label also requires product providers to demonstrate consideration of additional factors, such as appropriate management fees, and the method of selecting underlying investments. It also requires that the provider make available up to date data on underlying investments and uptake. However, Finansol <u>does not label an association, a company or a financial institution as a whole</u>.	Pros - Could be suitable for providers that only offer social investments Cons - Likely to be highly challenging in practice for individual providers to receive accreditation, when one provider is likely to offer a range of different products.
2.	**Fund**	This is typically where the majority of forms of labelling and accreditation of ethical or sustainable savings and investment products sit**,** for example: **Finansol Label** in France, labels individual solidarity savings products or funds that are accredited by the French Financial Markets Regulator **The FNG Label** is a quality standard for sustainable mutual funds that covers German speaking countries. The Label's minimum requirements consist of transparency and process criteria[35] and adherence to standards set by the UN Global Compact with regard to sustainable investment **The Climate Bond Standards Board**[36] verifies that funds are used to finance projects and assets that deliver a low carbon economy **The Green Bond Principles** are voluntary process guidelines that recommend transparency and disclosure when issuing Green Bonds	Pros - Track record of existing accreditation schemes that demonstrate different approaches and frameworks for establishing independent and credible process standards and accreditation criteria. Cons – diversity of different social investment assets and product/ channels would make it challenging to develop an all-encompassing framework for social investments
3.	**Underlying investment (into an organisation)**	**In France,** the government accredits solidarity organisations, based on a defined set of criteria	Cons – to an extent, legal form already acts as a form of accreditation, with regulated social sector organisations recognised in law as impact-creating organisations
4.	**Underlying investments (into a specific product)**	**Community Shares Standards Mark** – awarded to organisations issuing Community Shares for direct investment by individuals that meet criteria that ensure the quality and integrity of a share offer. The assessment is carried out by a licensed practitioner. **Threadneedle Social Bond Fund** – the partnership with social investment intermediary Big Issue Invest, with a long-established record in managing social investments, provides assurance on the social impact of the bond fund.	Pros: Could work for specific types of assets (e.g., social bonds) Cons: Highly complex, for example, to accredit or label the underlying social investments in a fund that could include highly diverse social investment assets
5.	**Investor**	Potential for self-certified "social investor label" Some evidence from Barclays identified that certain types of social investors derive personal satisfaction from doing social or environmental good[37]	Pros: Evidence to suggest some individual may be motivated by self-identifying as a social investor Cons: Could be challenging from an investor protection point of view

We recommend the following approach in the UK:

Structure and criteria

In principle, we would recommend accreditation of social investment funds that are then labelled by an independent body. Fund accreditation could be based on the proportion of underlying investment that are channelled into social investments. In practice, this could include regulated social sector organisations, and broader social purpose assets.

[35] https://www.eurosif.org/fng-label-2017-first-signs-of-a-positive-impact-on-sustainable-investment-funds/
[36] https://www.climatebonds.net/standards/certification/get-certified
[37] Barclays, The Value of Being Human: A Behavioural Framework for Impact Investing and Philanthropy September 2015

There is value in maintaining separation between the accreditation and labelling bodies, though an alternative structure could include accreditation and labelling carried out by an independent body with legal and regulatory backing.

Dual criteria around transparency and proportion of the fund channelled to genuine social investments

Again, a UK model could replicate the framework developed in France:

- Transparency – a requirement for social fund providers to provide regular information to savers/ investors, and any labelling body
- Social investments – a requirement for a social fund option to invest a minimum threshold of assets in social investments

If a social pension proposition were developed, where a portion of the fund was channelled into social investments, labelling options would include:

- A label on the social pension fund level
- A label on the 'social' portion of the fund (likely to be less than 10% of assets).

Governance

Any set of accreditation criteria and the award of any label should be carried out by an independent committee (as with Finansol) with members from across the social and mainstream investment market with a depth and breadth of relevant knowledge. This committee could include representation from Big Society Capital. Independence will bring credibility and trust alongside relevant expertise. Governance should ensure that the accreditation system and criteria are proportionate and cost efficient.

Problem	Recommendation
Need for accreditation and labelling of social investment options to give confidence to investors and reduce the risk of 'social washing'	13. Consider whether the FCA could provide regulatory backing to empower and independent body to accredit and label social pension fund options

Building a pathway over time

Given the diversity of social investment assets a labelling or accreditation system should start with certain types of assets first, to establish a pathway for clear and credible labelling – for example, on social property funds. Once established and understood by investors and the market, labelling for more diverse, illiquid and potentially higher risk social investment products or funds could be considered. It is important to acknowledge that social investment assets are diverse. What constitutes a social investment to one investor may not to another investor. This is why transparency must be a central tenant of any labelling system. Access to clear, accurate and accessible information on where funds are invested and on the criteria and basis of any labelling system will improve the chances that investors are able to make informed choices that align with their values.

A number of challenges would need to overcome for any accreditation system to be successful

Though the comments above provide a very high level sense of how a labelling or accreditation system could work in practice, a number of potential challenges emerge from this that require further detailed consideration:

- **'Ticking the ethical box'** - with regard to a label for a social pension fund closely aligned to the 90/10 structure outlined, there is the risk that having chosen such as fund (most likely as a 'chosen' fund) trustees feel they have 'ticked the ethical box' and as a result do not need to further of fully engage with ESG risks that may be considered both ethical issues and issues that have a material financial impact.
- **What is a social investment** - How easy will it practically be to deem 'what is social'? To an extent, this will always be up to the investor, but in early stages of market, a kitemark or label could build early confidence and credibility to grow engagement
- **Market development** - The social investment market is moving very fast - any accreditation will need to accurately reflect market practice to ensure it remains robust and relevant

Question 9 (10): 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. It is our view, alongside others including Bates Wells & Braithwaite London, that the policy context and regulatory framework for the social economy in the UK is fragmented and in places, inconsistent. This is an area that has been explored in some detail elsewhere, however, we highlight two areas below where intervention may still be required: firstly, the need for a 'Social Economy Commission' as the principal regulator of the social economy, with a policy and regulatory brief spanning as far as possible across the social economy. On this point, we agree with recommendations made by Bates Wells & Braithwaite London [38]. Secondly, we highlight the need for a Register of Charges for Charitable Incorporate Organisations to make it easier for these organisations to raise the finance they require.

A 'Social Economy Commission' is required to act as the principal regulator of the social economy

The social economy is incredibly diverse in legal status and legal form. The social economy comprises charities (which in turn come in a number of legal forms), co-operatives, community benefit societies, community interest companies, companies limited by guarantee, companies limited by shares with a social purpose, unincorporated associations and many others. There is neither one Government department nor one registrar or regulator of legal forms which has responsibility spanning the range of organisations in the social economy in the UK. For example, Community Interest Companies (CICs) have a CIC Regulator, whilst the FCA acts as registrar for Co-operatives and Community Benefit Societies.

The Government should convert the Office of the Regulator of Community Interest Companies into a 'Social Economy Commission', as the principal regulator of the social economy, with a policy and regulatory brief spanning as far as possible across the social economy.

The Social Economy Commission should be the registrar and regulator of community interest companies, co-operatives and community benefit societies. In time, the Social Economy Commission could also be given responsibility for the registration and regulation of Social Investment Vehicles and of Social Purpose Businesses or other social purpose organisations, if introduced. It would be a repository of deep and wide regulatory and policy knowledge with respect to the social economy as a whole.

For a more detailed explanation, please refer to 'Ten reforms to grow the social investment market', Bates Wells & Braithwaite, 2012'.

A register of charges for CIOs would make it easier for them to access appropriate finance

Charitable Incorporated Organisations (CIOs) are becoming more popular as a legal form for registered charities. All CIOs must be registered with the Charity Commission but does not have the income threshold, allowing for smaller organisations to gain funding. Unlike other legal forms of charities a CIO cannot exist as an entity without being registered with the Charity Commission. 2,016 CIOs were registered in 2014, making up 41.4% of all charity registrations in England and Wales during the year.

Having its own legal personality should make it easier for CIOs to hold property, employ staff and enter into contracts, however, the Charity Commission does not maintain a public register of charges (and there is no other searchable public register of charges which apply to CIOs) which may adversely affect the ability of CIOs to borrow money. This means that CIOs are unable to register a charge (as security provided for a loan) on any publically available register, apart from land that can be registered on the Land Registry. In practice, this makes it very challenging for CIOs to take on secured loans.

[38] See 'Ten reforms to grow the social investment market', Bates Wells & Braithwaite, 2012. Available here: http://www.bwbllp.com/file/bwb-20ten-20reforms-20to-20grow-20the-20social-20investment-20market-20july-202012-pdf

Without a public register of charges, it is very hard for investors to determine what other security might have priority over theirs. This acts as a perceived barrier and can make it more challenging for CIOs to access secured investment.

Problem	**Recommendation**
The regulatory framework for the social economy in the UK is fragmented and in places, inconsistent	14. Establish a social economy commission to act as the principal regulator of the social economy
Lack of public register of charges may make it difficult for CIOs to access certain types of finance	15. Make a provision in CIO legislation for the maintenance of a register of charges

Sackers

Appendix 1

Social Investment

Legal advice on barriers to investment

Introduction

We have been asked to provide a legal commentary to Big Society Capital on the barriers that exist in relation to investment by pension funds in social investments.

This note sets out our factual advice on the barriers, based on the current legal framework around pension fund investment. We give our assessment of the legal barriers which we believe exist and a brief commentary on the non-legal barriers so far as we are aware of them.

We do not comment on matters of policy or make any recommendations for policy changes in relation to the barriers that may exist. We are, however, happy for Big Society Capital Limited to use this advice as a legal background to inform their views and to enable them to make their own recommendations on matters of policy.

A. Questions 1 and 2

What are the barriers to DC pension funds investing:

(a) in infrastructure generally?

(b) in socially significant infrastructure?

(c) in other forms of social investments?

Do any of those barriers relate to issues of law and regulation?

A.1 Background

A.1.1 We consider that a there are a number of barriers to pension funds investing in these areas. Some of these are legal and some are not. We consider that the barriers to investment from a legal perspective can be grouped as follows:

- Fiduciary duties
- Regulatory barriers

A.1.2 In sections A.2 to A.5 below we set out in further details how these barriers manifest themselves in relation to infrastructure generally; socially significant infrastructure; and other forms of social investments. We approach this from the point of view of different types of pension schemes – specifically, trust based and contract based defined contribution ("DC") pension schemes. The law also applies differently to default funds offered by DC schemes, compared to member chosen funds.

A.1.3 In addition to the legal barriers identified, there are a number of potential structural barriers to investment. These are beyond the scope of our legal advice. However we provide a general commentary on our perceptions in this area as they apply to this question in section A.6 below. Broadly our observations as to the main structural barriers to investment are as follows:

- Pricing and liquidity constraints
- Inertial barriers
- Governance budget
- Member communication difficulties

A.2 Fiduciary duties – trust-based schemes (general)

Financial best interests

A.2.1 Pension trustees have a fiduciary duty to invest pension trust assets in the best interests of scheme members and beneficiaries.

A.2.2 In July 2014, the Law Commission published its report on the Fiduciary Duties of Investment Intermediaries. Among other things their report made clear that, in a pension scheme context, a trustee's core duty is to promote the purpose for which the trust was created – namely, to provide pensions and therefore to act in the best "financial interests" of the scheme's beneficiaries. We agree with this assessment of the legal position.

A.2.3 It remains important, however, to consider this duty in context. Trustees are required to balance returns against risk when investing trust assets and the best financial interests of a pension scheme's beneficiaries are not to be equated with simply "maximising returns".

A.2.4 Trustees should first consider what they are trying to achieve with a particular strategy or portfolio, and only then consider how the financial interests of the scheme's beneficiaries are best served in relation to that strategy. The objective of the strategy will dictate what is financially relevant to the selection of an appropriate investment to deliver on that strategy. This might be anything from outperforming an index to hedging against a risk such as changes in the rate of interest or inflation. The objectives are also unlikely to be the same throughout a pension fund's investment portfolio. Different parts of the portfolio may have different objectives and strategies at different times.

A.2.5 Once trustees have determined their objectives, investment decisions taken (e.g. the selection of an investment) need to distinguish between those factors that are financially relevant to the decision and those which are not. In selecting investments trustees should take account of any factor which is financially material to the performance of the investment. Performance in this context might include return or management of an identified risk. Factors to be considered may include environmental, social and governance ("ESG") factors pertinent to the investment as a financial proposition. It should be noted that ESG factors in this context are about improving financial outcomes for the beneficiaries: they are not about ethical preferences.

Non-financial factors

A.2.6 In its report on the Fiduciary Duties of Investment Intermediaries the Law Commission also considered the extent to which other factors might be taken into account by trustees making investment decisions. Among other things the Law Commission concluded that:

- "purely ethical" concerns, designed to show moral disapproval of activities, may only be taken into account if two conditions are satisfied. Firstly, the trustees must have good reason to think that scheme members would share the ethical/moral view. Secondly, they should anticipate that the decision will not result in material financial detriment to the scheme.

- "quality of life factors" (that is, factors relating to beneficiaries' quality of life now and in the future) may only be taken into account when choosing between two equally beneficial investments. They may not be taken into account when this would result in a lower return.

A.3 Applying fiduciary duties to DC trust-based schemes

A.3.1 For trust based schemes which provide defined benefits, the trustee duty is to invest the scheme's assets appropriately to pay the scheme's promised benefits. However, in a DC scheme, the objectives are more subtle and may best be thought of as having two key components:

- to establish a default fund appropriate to the needs of the membership, keeping this under review and updating it as necessary, and

- to ensure an appropriate choice of investment arrangements ("chosen funds") for those members who do not wish to invest in the default arrangement.

Default funds

A.3.2 In relation to a default fund, traditionally trustees will have aimed to provide a fund which provides investment growth in relation to the member and employer contributions made in order to provide a sum of money for a member which can be used to provide him or her with a retirement income. A common approach was to invest for growth in the years furthest from retirement (when greater volatility can be tolerated) and gradually transition to more stable investments that expose a member's accumulated capital to less volatility as the member gets closer to retirement age.

A.3.3 Since the recent introduction of greater pension flexibilities, however, not all pension scheme members can be assumed to be investing for an "income" in retirement. Trustees must therefore consider the needs of their membership and determine what the purpose of the default fund is to be in relation to their particular scheme.

A.3.4 As noted above, once the objectives have been determined the trustees must select an appropriate investment fund or a combination of funds to comprise the scheme's default fund. In making that selection the trustees may take account of any factor which is financially material to the objectives they have set.

A.3.5 Trustees of defined contribution schemes must consider whether a given investment will serve the financial best interests of a pension scheme member in order to include such an investment in a default fund.

A.3.6 Whilst this does not of itself rule out an investment in infrastructure, socially significant infrastructure or any other forms of social investments, the test must always be met in relation to the investment that its selection as part of a scheme's default fund must be on the basis that it will serve the best financial interests of the scheme's members.

A.3.7 It may therefore not be helpful to say that fiduciary duties will always be a barrier to the inclusion of infrastructure, socially significant infrastructure or other forms of social investments in a default fund. Indeed in defined benefit schemes trustees have successfully invested in infrastructure (and socially significant infrastructure) for many years in a manner entirely consistent with their fiduciary duties to invest in the best financial interests of the scheme's beneficiaries.

A.3.8 Instead we think the issue is more subtly put as follows: trustee fiduciary duties may preclude them from some types of investment where those investments pursue social objectives which introduce a financial downside to the

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investment that would not otherwise exist and where the trustees could invest in a similar fund that did not have such a downside.

A.3.9 However, as noted above, what should be considered as a "financial downside" is not simply a matter of looking at returns. Trustees must consider their objectives and consider financial issues in the context of those objectives. Within a growth part of a default fund fiduciary duties would preclude the trustee selection of a social investment which in part sacrifices return as part of its objectives. However, within the part of a default fund which aims to expose a member's accumulated capital to less volatility (e.g. as the member gets closer to retirement) a targeted lower return may be acceptable from an investment, if it has other objectives that are financially attractive to the member from a risk reduction point of view and where those objectives are equally capable of being met from a fund pursuing social objectives as one which is not. On this point we do not comment on whether social investments might be constructed in such a way. Merely we seek to point out that the assessment of whether a social investment is in members best financial interests or not must be considered within the context of the trustees' investment objective for the relevant aspect of the default fund.

Chosen funds

A.3.10 Although the trustees' legal duty is to act in members' best financial interests when investing on their behalf in the default fund, when members make their own investment choices they are not quite so constrained. As the Law Commission noted in its report, members may legitimately decide to sacrifice some income in old age for ethical concerns. Provided that decision is fully informed, trustees cannot be criticised.

A.3.11 It is therefore perfectly appropriate for trustees to include funds for members to select which specifically take non-financial factors into account, even at the risk of financial detriment to the member.

A.3.12 On that basis we do not consider that trustee fiduciary duties will preclude trustees from offering infrastructure, socially significant infrastructure or other forms of social investments within a range of investment choices for member chosen funds even where those funds include some financial downside as a result of the particular investment objective pursued.

A.3.13 However, again the position is not a completely black and white assessment. The fact that an investment is member chosen does not absolve trustees from fiduciary duties in respect of it. Trustees remain responsible for monitoring all investments offered to their members and ensuring that they remain appropriate to their members' needs. Trustee fiduciary duties include regularly reviewing the performance of chosen funds used by members against their performance objectives and industry benchmarks where available. If funds are not performing trustees should consider changing them.

A.3.14 Again this fiduciary duty does not preclude trustees from offering infrastructure, socially significant infrastructure or other forms of social investments. However, it does introduce a practical issue in that the more funds are offered and the more diverse their objectives, the greater the burden of monitoring them is likely to become. Greater care will also need to be taken in member communications to ensure that members are fully informed about the nature of an investment which run a risk of financial detriment to the member.

A.3.15 We note these below as a potential structural barriers in section A.6 below.

Financial detriment

A.3.16 As noted above, trustees should not take factors into account which they consider will result in material financial detriment. We have been asked to comment on what is likely to be "material" in this context.

A.3.17 In the context of a DC default fund we consider that the threshold is likely to be extremely low.

A.3.18 In a defined benefit scheme with large assets and a strong employer covenant, it may be possible to identify some issues as financially immaterial from an investment point of view. However, in a DC scheme where member's benefits are directly correlated to the size of their investment fund we do not consider that trustees should seek to rely on this as justification for a particular approach. In other words, where trustees have a choice of investments we would not consider it appropriate to select the one which they consider to be worse as a financial proposition simply on the basis that they do not consider it to be much worse.

The views of members

A.3.19 As noted above, generally speaking, non-financial factors unrelated to risks, returns, or the interests of beneficiaries should be ignored by trustees in their investment decision making. However, the law does offer some flexibility for trustees to take non-financial factors into account where two tests are met:

- the trustees must have good reason to think members will share the viewpoint, and
- the decision must not risk material financial detriment to the pension scheme.

A.3.20 The former point can be problematic in relation to ethical and moral issues, where the ethical view of members may vary. It may therefore be difficult for trustees to have confidence that members will necessarily share a common view. However, within the context of social investments, arguably trustees may feel more confident in making that assessment without the need for extensive survey evidence.

A.3.21 As the Law Commission observed, trustees may look for good infrastructure schemes which will both improve quality of life and provide good financial returns. And where two projects appear equally beneficial, trustees may choose the investment which will most improve beneficiaries' quality of life. This is on the basis that it may be reasonable to conclude that most scheme members would support such an objective welcoming the lifestyle benefit.

A.3.22 However, in any event financial considerations (to pay retirement and other benefits) must be the primary objective. For the default fund, the trustees' assessment of an investment should be based on their consideration as to how its inclusion will serve the best financial interests of the scheme's members. If it does then the trustees may properly consider it as a potential component of their default fund. If it does not they must not.

A.3.23 For the reasons set out above we consider that that is the more likely barrier to social investments as far as fiduciary duties are concerned.

A.3.24 In relation to chosen funds, trustees merely need to form a view on whether the members are likely to want such a fund. But here the fiduciary duty might be considered in reverse. If trustees were to offer a fund that members did not want (and consequently did not chose to invest in) there is unlikely to have been any breach of fiduciary duty. By contrast not making funds available where there is a clear member desire for them is probably the greater legal risk.

A.4 Fiduciary duties in contract based schemes

A.4.1 Group personal pensions are increasingly used by employers instead of trust based arrangements. The fiduciary duties of the parties involved in contract based pensions, however, are less clear than for trust based schemes.

A.4.2 Typically an employer will choose the scheme and may make arrangements to collect and pay contributions on behalf of members. However, in legal terms, the scheme is characterised as a contract between each employee and the pension provider. Beyond its initial selection, the employer will have only a limited role in the ongoing monitoring of the scheme. Since April 2015, FCA rules also require firms that operate workplace personal pension schemes to establish and maintain Independent Governance Committees (IGCs). The role of an IGC is to act independently of their pension provider and scrutinise the value for money of the provider's workplace personal pension schemes, taking into account transaction costs, raising concerns and making recommendations to the provider's board as appropriate.

A.4.3 The extent to which employers, IGCs and providers themselves each owe a fiduciary duty to pension scheme members is debatable, although it is clear that each owes a duty of care to some extent.

A.4.4 The issues covered in section A.3 above in relation to the inclusion of infrastructure, socially significant infrastructure or other forms of social investments in a default fund are therefore likely to be similar between contract-based and trust based schemes – i.e. it will be difficult for any parties involved to select a default fund based on criteria which are not in the best financial interests of the scheme's members.

A.4.5 However, in relation to the provision of a range of chosen funds, fiduciary duties are less likely to be a barrier. Provided an employer has made a suitable range of investment options available to its employees the duties can probably be considered to be limited to:

- an obligation on providers to ensure that fund descriptions provide a sufficient description of the nature and risks of each of the funds on offer in sufficient detail to enable a member to take an informed decision whether or not to choose it; and
- an obligation on IGCs to ensure that funds offer value for money to members.

We do not consider that either of these would be a barrier to the provision of infrastructure, socially significant infrastructure or other forms of social investments within a range of investment choices for member chosen funds in a contract-based scheme.

A.5 Summary of potential fiduciary barriers

	Potential fiduciary barriers
Default Fund	Assessment of an investment should be based on consideration as to how its inclusion will serve the best financial interests of the scheme's members. A.5.1 This is likely to act as a barrier to some forms of social investment which specifically sacrifice return or introduce greater financial risks in exchange for the furtherance of a social aim.
Chosen Funds	Funds may be offered which specifically take non-financial factors into account, even at the risk of financial detriment to the member. **A.5.2** However, care must be taken in member communications to ensure that members are fully informed about the nature of the investment. Trustees will also remain responsible for ongoing monitoring of funds offered. **A.5.3** Whilst not a barrier to social investments, these points would need to be taken into account in practice.

A.6 Regulatory barriers

Pensions Investment

A.6.1 Regulation 4 of the Occupational Pension Schemes (Investment) Regulations 2005 requires trustees to invest in members' best interests. This is backed up by a number of further requirements including express obligations to:

- invest in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole;
- invest in a manner appropriate to the nature and duration of the expected future retirement benefits payable under the scheme;
- invest predominantly in regulated markets and only prudently outside such markets
- to ensure that the assets of the scheme are properly diversified avoiding excessive risk concentration.

A.6.2 It would be possible to discuss at length the extent to which Regulation 4 qualifies or adds to a trustee's fiduciary duties but, in this context, we think it is enough to note that the obligations are broadly consistent.

A.6.3 The application of these rules to a member chosen DC arrangement is not entirely straightforward. In the DC context, the Trustee is usually only in control of the fund choices on offer. It may not have the power to control the members' allocations to those funds. Accordingly, if a member chooses to invest all of their assets in one fund they may well not be properly diversified. The Trustees are, in our view, properly discharging their obligations by applying these regulations within the context of the investment decisions they have.

A.6.4 We do not see anything in these regulations which would prevent the offering of a social fund as a member chosen fund provided the scheme's offering as a whole meets the regulatory requirements and subject, of course, to clear labelling. We return to the requirement to provide appropriately liquid assets below under section A6.

Permitted links

A.6.5 Defined contribution schemes are typically offered through an insurance platform. The platform allows the member (whether directly or through a trust based scheme) to access particular funds offered under the platform.

A.6.6 Insurers achieve this by writing linked business. The member (or scheme) will have an insurance policy with the insurer. The value of the policy tracks the underlying fund or funds selected by the member. Insurers are only permitted to write this sort of business where the value of the member's units is derived from assets which are "permitted links".

A.6.7 Managers operating social funds will need to structure their collective investment schemes to be "permitted links" if they are to be offered under defined contribution platforms under the current regime. This may prove challenging in practice for collective investment schemes structured along the models we have typical seen for private equity or infrastructure. This does not, of course, mean that collective investment schemes which are themselves "permitted links" might not include within their portfolios third party managed funds which would not be permitted links on their own account (for example a "fund of funds" type arrangement).

A.7 Structural barriers

Investment in illiquid assets

A.7.1 There is no explicit regulatory requirement to only offer highly liquid funds in DC schemes. In practice, however, Trustees will want to make sure that members are only invested in assets which are sufficiently liquid to ensure that the Trustee can fund transfer requests or member liabilities which occur before retirement age.

A.7.2 A key issue in this context is that most members will have a statutory right under the Pensions Act 1993 to transfer their DC pension pot to another registered pension scheme (see A.7.5 below). Such transfer requests usually have to be satisfied within 6 months.

A.7.3 Some of the investment strategies contemplated within the "social" bracket (particularly those with an infrastructure slant) are likely to be offered by managers who operate in what can loosely be described a private equity or infrastructure model, by which we mean the funds are typically structured as follows:

- at subscription, investors commit to meet draw down requests up to a specified amount. Minimum commitments of at least £10 million usually apply.
- Up to 100% of the commitment is drawn down on an as-needed basis during a specified investment period (typically 2 to 5 years) as and when investment opportunities are identified by the manager.
- The fund will only begin distribution towards the end of its term which could be 10 or 15 years.
- During the term, an interest in the fund cannot be redeemed and a secondary market cannot be assumed.

A.7.4 This structure is not problematic for larger DB pension schemes, where illiquid asset classes will form part of a diversified long term strategy for the scheme as a whole and where the large sums of money required to make capital commitments on this scale are available.

A.7.5 However, DC pension schemes and funds with this drawdown and distribution profile are not structurally well matched. In practice this sort of fund is not directly available on DC platforms. There are two elements to this:

(a) The member and employer contribution stream received by a DC pension scheme must be invested as soon as possible to maximise the investment return for the member. This sits uncomfortably with the draw-down process outlined above which requires large lump sum payments at irregular intervals.

(b) In theory a very illiquid fund should not be inconceivable for a pension scheme saver who might expect to be saving over the long term in normal circumstances. However pension scheme trustees or providers need liquid assets to meet liabilities that arise outside the typical run of events:

- Early retirement/Ill-health/serious ill health/death –members typically have the ability to bring their pension into payment before their normal retirement age from the age of 55 or earlier if they suffer ill health. On serious ill-health, the entire benefit may be payable as a lump sum. A cash lump sum or pension will typically also become payable to a members' dependent on the member's death.
- Transfer values – As noted above, most members will have a statutory right under the Pensions Act 1993 to transfer money purchase benefits from a DC Pension scheme to another registered pension scheme. This may be in addition to any transfer right under a schemes rules. Such transfer requests usually have to be satisfied within 6 months.

In the DC context, these liabilities will need to be met by liquidating the member's units. Assuming the Trustee has offered the scheme through a typical investment platform, the platform provider will have the right not to redeem units if it is unable to redeem the underlying linked investments. This would put the Trustee in the invidious situation of having an obligation to the member without available assets to meet that obligation.

A.7.6 To manage these issues, in our experience, DC Trustees only access illiquid strategies indirectly. They may choose diversified or multi-strategy collective investment schemes where illiquid elements are bundles with other assets to keep illiquidity at prudent levels (see also the restrictions on "permitted links" mentioned above under paragraphs A.5.5-7 above).

This will, of course, result in additional fees and expense and have consequences for the investment characteristics of the asset.

A.7.7 We have been asked to consider the proposal of a "90/10" fund (a "**90/10 Fund**") in the context of liquidity, by which we understand a (probably) member chosen DC social fund with the following features:

- 90% of the 90/10 Fund's assets chosen to target on a traditional risk adjusted return;
- the remaining 10% will have an overt social objective which might result in a lesser return.
- for the purpose of this example, we assume that some or all of the 10% is invested in infrastructure or private equity equivalent assets which are very illiquid (it is not uncommon for an infrastructure limited partnership to have a 10 or 15 year term during which it cannot be redeemed. A secondary market may not be available.)
- We have assumed that the 90/10 Fund can be structured to qualify as a "permitted link".

A.7.8 If a DC member chose to invest all or part of their pension in the 90/10 Fund and subsequently chose to transfer, that transfer request would need to be met from the 90% portion. As long as the 90/10 Fund has sufficient scale, such redemptions should be unproblematic. However, without such scale, it might prove difficult to maintain the 90/10 balance over time.

Inertial barriers

A.7.9 Section 36(3) of the Pensions Act 1995 requires that before investing in any manner (other than in a manner mentioned in Part I of Schedule 1 to the Trustee Investments Act 1961) trustees must obtain and consider "proper advice" on the question whether an investment is satisfactory having regard to the requirements of the Occupational Pension Schemes (Investment) Regulations 2005, so far as relating to the suitability of investments, and to the Scheme's Statement of Investment Principles.

A.7.10 This only applies if the Trustee itself is making the decision to invest, not if a manager makes the decision under a discretionary mandate. However, in most cases trustees of trust-based DC arrangements will be selecting pooled funds to which the advice requirement will apply.

A.7.11 The need for advice is not of itself a regulatory barrier to the selection of infrastructure, socially significant infrastructure or other forms of social investments within a DC scheme. However, in practice, our experience is that most trustees (particularly of smaller schemes) tend to select established investments with which their advisers are familiar and can recommend without having to do extensive and bespoke due diligence. There may therefore be considered to be an inertial barrier to new investment products which are not mainstream.

Governance budget

A.7.12 As noted above, trustee fiduciary duties include regularly reviewing the performance of chosen funds. The more funds are offered and the more diverse their objectives, the greater the burden of monitoring them is likely to become. In relation to social investments, where the objectives may be more complex than simply generating a return above a benchmark, we consider that the monitoring obligation may be perceived as an additional burden. For smaller schemes with limited governance time, this may be a perceived barrier.

Member communication difficulties

A.7.13 As noted above, there is an obligation on a contract-based provider to ensure that fund descriptions provide a sufficient description of the nature and risks of each of the funds on offer in sufficient detail to enable a member to take an informed decision whether or not to choose it. Although this is a specific requirement under FCA Rules for providers in contract-based schemes, fiduciary duties in trust based schemes impose similar duties on trustees. There may be a perceived barrier in relation to funds which have both financial and non-financial objectives.

B. Question 3

In relation to question 1 above, is the size of funds a major issue? If so, are there legal obstacles to scheme mergers?

B.1 Scheme size

B.1.1 Aside from very small schemes (where certain regulatory requirements do not apply), we do not consider that scheme size of itself creates any material difference in fiduciary or regulatory barriers to investment in infrastructure, socially significant infrastructure or other forms of social investments.

B.1.2 However, in relation to the structural barriers listed in section A.6 above, we consider that larger schemes will tend to be better placed to overcome these barriers.

B.1.3 A large trust-based scheme with significant assets in its default fund may be better placed to tolerate some illiquidity in relation to a small proportion of its assets and still be able to maintain liquidity at an overall fund level sufficient to satisfy member transfer requests promptly. Similarly larger schemes are likely to have trustee boards capable of devoting greater time and expense overcoming inertial and governance issues which may be disproportionate for a smaller scheme.

B.1.4 The issues of increasing governance and regulatory obligations becoming disproportionate in small trust based DC schemes is well documented and there are legal processes permitting such schemes to be merged. However, in our experience it is more likely that an employer operating a small trust-based DC scheme for its employees will look at moving to a contract based arrangement or a master-trust in order to reduce governance. In practice we consider that such changes are unlikely to be driven by issues relating to investment in infrastructure, socially significant infrastructure or other forms of social investments.

Appendix 2

Relevant learning objectives related to establishing “suitability” which are included in the Adviser Competency Training for social investment syllabus (from the Worthstone Social Investment Academy)

- Explain what motivates clients to invest in social investment projects
- Explain how to identify the client’s specific areas of interest in social goals and the similarities and differences between this and the conventional discovery process
- Explain the possible financial products to achieve social objectives and how to compare these
- Explain the approach to, and process of, asset segmentation within a client’s portfolio and describe how to establish and map client's return priorities on a spectrum of possibilities
- Explain how social return and financial return can be blended within a single investment offering.
