IN THE MATTER OF:

THE LEGAL DUTIES OF PENSION FUND TRUSTEES
IN RELATION TO CLIMATE CHANGE

ABRIDGED JOINT OPINION

Introduction

1. We are instructed by ClientEarth, an environmental law NGO and registered charity. ClientEarth has been considering the legal duties of pension fund trustees (specifically the trustees of occupational pension schemes ¹) to assess the financial risks associated with climate change when making investment decisions on behalf of scheme members.

2. We have been asked, in broad terms, to advise on the extent to which the law permits and/or requires trustees of occupational pension schemes to take the financial risks associated with climate change into account when making investment decisions².

3. ClientEarth’s concern is that there is confusion amongst trustees as to their legal duty to consider financial risks associated with climate change. Historically, climate change has been seen as purely an environmental concern and has been bracketed with other ethical concerns. There is now a growing body of evidence to the effect that climate change gives rise to material financial risks which, ClientEarth say, should be taken into account by trustees.

¹ As defined by section 1 of the Pension Schemes Act 1993 (‘PSA’).
² We emphasise that this is an abridged version of a fuller written Opinion already given to ClientEarth and is therefore only a summary of some of our views. Further, this (and our previous) Opinion have been provided solely for the benefit of ClientEarth. Any advice herein should not be relied on by any other party who should take their own legal advice.
The hypothetical scenario

4. We have been asked to base this advice on a hypothetical scenario. The hypothetical pension scheme under consideration is referred to below as Pension Fund X; where we occasionally refer below to 'the Fund' that too is intended to refer to Pension Fund X.

5. Pension Fund X is a trust-based defined contribution scheme where, as is common, day-to-day investment decisions are delegated to external fund managers.

6. One of the trustees of Pension Fund X is concerned about risks to the Fund associated with climate change and (supported by some of the members) wants the trustees of Pension Fund X to take steps (or to instruct its fund managers to take steps) to assess and, if appropriate, manage those risks. The concerned trustee thinks that his fellow trustees should consider taking steps such as (a) considering risk associated with climate change in their next strategy review and asset allocation decisions and (b) paying more attention to stewardship and being more proactive in directing their fund managers to vote in particular ways on shareholder resolutions related to climate change risks, eg by adding these issues to their Statement of Investment Principles (‘SIP’).

7. The other trustees are reluctant to spend time and the Fund's money looking into these matters and (a) are not sure whether in fact they are legally permitted to take climate change into account as it has moral and ethical implications and (b) argue that they have delegated their day-to-day investment decisions to fund managers so are neither permitted nor required to concern themselves with these issues.

8. With this hypothetical scenario in mind, we have been asked to advise on the extent to which the law permits and/or requires trustees of occupational pension schemes to take climate change into account when making investment decisions.

---

3 As set out in ¶1 above we proceed on the basis that Pension Fund X is an occupational pension scheme as defined in the PSA.
The Law

9. The law in relation to the investment duties of trustees arises from three separate (but inter-related) strands, namely:

   (a) the governing provisions of the Fund;
   (b) common law duties;
   (c) relevant statutory provisions.

The Law – the Fund’s governing provisions

10. The starting point when considering the powers and obligations of pension scheme trustees is generally to examine the scheme’s governing provisions, ie the Trust Deed and Rules for a trust-based scheme. In this case, as we are proceeding on a hypothetical basis, we cannot examine Pension Fund X’s governing provisions. However, for present purposes we assume that its governing provisions are standard in nature and that they (a) give the trustees broad powers of investment and (b) provide that the trustees can delegate their investment functions to a fund manager (as, in our hypothetical scenario, they have done).

11. Accordingly, in our hypothetical scenario the governing provisions are silent as to taking account of climate change risk (and any other financial and/or environmental, social and governance (“ESG”) factor). Therefore, if there is a restriction on the trustees’ investment powers then it is to be found in the common law and/or applicable pensions legislation.

The Law – common law duty

12. When considering a trustee’s duties when exercising a power of investment the starting point in terms of case law is the frequently cited judgment of Sir

---

4 Although section 34 of the Pensions Act 1995 (‘PA95’) gives trustees a statutory power to make ‘an investment of any kind as if they were absolutely entitled to the assets of the scheme’ this is subject to any restrictions imposed by the governing provisions of the trust. So, for example, a trust deed and rules may specifically prohibit investment in a particular type or class of investment (eg tobacco, arms, fossil fuels etc) and that prohibition would bind the trustees notwithstanding the provisions of section 34. We assume here that the governing provisions of Pension Fund X do not contain any such prohibition.
Robert Megarry V-C in *Cowan v Scargill* ([1985] Ch 270). As to the standard required of trustees when exercising their powers of investment, the Vice-Chancellor adopted (at 289B of his judgment) the long-established formulation that the trustee must:

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

13. As to what the investment duty required, he said this (at 286H):

‘When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests.’

14. As a corollary of the point made above, he then said (at 287G):

‘In considering what investments to make trustees must put on one side their own personal interests and views. Trustees may have strongly held social or political views. They may be firmly opposed to any investment in South Africa or other countries, or they may object to any form of investment in companies concerned with alcohol, tobacco, armaments or many other things. In the conduct of their own affairs, of course, they are free to abstain from making any such investments. Yet under a trust, if investments of this type would be more beneficial to the beneficiaries than other investments, the trustees must not refrain from making the investments by reasons of the view that they hold.’

15. What is clear from the two passages set out above is that the Vice-Chancellor was plainly of the view that trustees must exercise their power of investment in the best interests of the beneficiaries and this means their best financial interests. It follows that trustees should not take their own (or indeed any) ESG factors into account if these conflict with the financial interests of the beneficiaries.

---

5 Derived from *In re Whiteley* (1886) 33 Ch D 347.

6 See also to similar effect the Scottish case of *Martin v The City of Edinburgh District Council* [1989] PLR at ¶33 where Lord Murray said that although a trustee should not be expected to divest himself of all personal moral and political preferences, since this would not be reasonable or practicable, he should ‘recognise that he has those preferences, commitments or principles but nonetheless do his best to exercise fair and impartial judgment on the merits of the issue before him. If he realises that he cannot do that, then
The 'best interests' principle has recently been revisited by Asplin J in *Merchant Navy Ratings Pension Fund Trustees Limited v Stena Line Limited and others* ([2015] EWHC 448 (Ch)). The facts of Stena are complicated but in essence the case concerned whether trustees could introduce a new contribution structure to the scheme in question. One of the main issues was whether the proposed amendments were in the best interests of the beneficiaries. Asplin J had to consider what 'acting in the best interests of the beneficiaries' meant. It is worth quoting ¶¶228-229 of her judgment in full:

'228. In this regard, I agree with Messrs Tennet, Green and Simmonds that the 'best interests of the beneficiaries' should not be viewed as a paramount stand-alone duty. In my judgment, it should not be treated as if it were separate from the proper purposes principle. In fact, it seems to me that the way in which the matter was put by Lord Nicholls’ extra judicially sums up the status of the best interests principle and the way it fits in to the duties of a trustee. It is necessary first to decide what is the purpose of the trust and what benefits were intended to be received by the beneficiaries before being in a position to decide whether a proposed course is for the benefit of the beneficiaries or in their best interests. As a result, I agree with his conclusion that ‘… to define the trustee's obligation in terms of acting in the best interests of the beneficiaries is to do nothing more than formulate in different words a trustee's obligation to promote the purpose for which the trust was created.’

229. In my judgment, it is clear from *Cowan v Scargill* that the purpose of the trust defines what the best interests are and that they are opposite sides of the same coin, an approach which is supported by the way in which the matter is dealt with in *Harries v Church Commissioners*, another case concerning investment policy and in *Australian Securities and Investments Commission v Australian Property Custodian Holdings Limited (No 3)* in which Murphy J made comments which were obiter in which he described the principle as a 'portmanteau'. The learned Judge's comments were made in the context of his consideration of a statutory duty to act in the best interests of the members of a trust. He explored the common law and equity in some depth and concluded that the statute did not extend beyond the general law.

---

7 This is a reference to an article written by Lord Nicholls entitled ‘Trustees and their broader community: where duty, morality and ethics converge’ (1995) 9(3) TLI 71 in which he said this: ‘Benefit and best interests are really interchangeable expressions. Both have a wide and elastic but not unlimited meaning. In this context, each requires an examination of the object with which the trust was established. To decide whether a proposed course is for the benefit of the beneficiaries or is in their best interests, it is necessary to decide first what is the purpose of the trust and what benefits were intended to be received by the beneficiaries. Thus, to define the trustee's obligation in terms of acting in the best interests of the beneficiaries is to do nothing more than formulate in different words a trustee's obligation to promote the purpose for which the trust was created.’
If by his conclusion that the ‘best interest duty’ operates ‘in combination with other duties’ he meant that it flows from and is moulded by the trustee’s obligation to promote the purpose for which the trust was created, I agree. As Lord Nicholls pointed out, first it is necessary to determine the purpose of the trust itself and the benefits which the beneficiaries are intended to receive before being in a position to decide whether a proposed course is in the best interests of those beneficiaries.’

17. As set out in the above passage, Asplin J held that the best interests principle was part and parcel of the principle that a power should be exercised to promote the purpose of a trust, ie what may be called the proper purpose principle. Accordingly, identifying what is in the best interests of the beneficiaries of a trust flows from identifying the purpose of the trust and the nature of the benefits that the members are intended to derive from it.

18. Asplin J’s approach to the best interests principle in Stena is consistent with the approach taken by Sir Donald Nicholls V-C in the earlier decision of Harries v Church Commissioners for England ([1992] 1 WLR 1241, ChD). In the context of examining the investment duties of the Church Commissioners he held (at 1246D) that:

‘Second, there is property held by trustees for the purposes of generating money, whether from income or capital growth, with which to further the work of the trust. In other words, property held by trustees as an investment. Where property is so held, prima facie the purposes of the trust will be best served by the trustees seeking to obtain therefrom the maximum return, whether by way of income or capital growth, which is consistent with commercial prudence. That is the starting point for all charity trustees when considering the exercise of their investment powers. Most charities need money; and the more of it there is available, the more the trustees can seek to accomplish.’ (emphasis added)

19. In our opinion, there is no conflict between Cowan, Harries and Stena or between the principles enunciated in those cases. The current preferred approach is to seek first to identify the purpose of the trust and then to determine what is in the best interests of its beneficiaries, but, as Asplin J

---

8 The Commissioners being analogous to the trustees of a charitable fund from which, inter alia, pensions were provided.

9 See also the decision of the Royal Court of Jersey in Abacus (CI) Ltd v Hirschfield and others (2001/195 4 ITELR at ¶10).
said in *Stena*, the proper purposes principle and the best interests principle are really two sides of the same coin.

20. Adopting that approach in the present context, it is clear, in our opinion, that the purpose of a pension trust is invariably to provide the members with pensions. Therefore, (subject to the below) a power of investment under a pension trust should always be exercised to further that purpose by seeking to maximise the pension benefits to be received by the members, ie the trustees should act in the best financial interests of the members.

21. Although taking non-financial considerations, such as moral or political views, into account will generally be inconsistent with acting in the best financial interests of members, our review of the relevant case law indicates that there can be certain exceptions to this:

(a) As discussed in *Cowan* and *Harries*, there might be circumstances in which, even if the purpose of a trust is to provide financial benefits, the trustees could exercise their power of investment in accordance with the moral views of the beneficiaries of the trust, ie take account of non-financial factors. If, for example, all the beneficiaries of a trust were adults and had strict moral beliefs about a certain industry (eg tobacco, arms, alcohol etc) then the trustees might properly exclude certain assets from the trust’s investment portfolio. However, as indicated in *Cowan*, ‘such cases are likely to be very rare, and in any case I think that under a trust for the provision of financial benefits the burden would rest, and rest heavy, on him who asserts that it is for the benefit of the beneficiaries as a whole to receive less by reason of the exclusion of some of the possibly more profitable forms of investment.’

(b) Second – although this point is probably limited to charitable trusts – as recognised in *Harries* there can be cases where an investment would conflict with the very objects of a charity, in which case they should not make that investment. We struggle to see how this issue could arise in a pensions context, especially in our hypothetical scenario which envisages that the trust provisions do not exclude any particular asset class or prescribe any particular investment policy.

---

10 Which is unlikely in the case of a pension trust, which would typically provide for benefits for dependants, including children.
(c) Third, as again discussed in Harries – and again this is probably restricted to charity cases – where particular types of investment are not inconsistent with the very object of the trust as such but might nevertheless hamper its work by making potential beneficiaries unwilling to accept help or alienating potential financial supporters. Trustees may take such factors, which are not strictly and directly financial, into account, but even then only to the extent that they would not give rise to a significant financial detriment to the trust’s funds.

(d) Fourth, and finally, as discussed in Cowan, it would be difficult to criticise trustees for investing on the basis of non-financial ESG factors if they were faced with two potential investments both of which were equally financially beneficial. However, this exception has an air of unreality to it as no investment choice is ever likely to have an identical twin in terms of anticipated investment performance.

22. Having set out briefly a number of potential exceptions to the principle that trustees must invest in the best financial interests of members, we do not see any of those exceptions as being pertinent to the hypothetical scenario under consideration here.

23. In our opinion, under common law, the trustees of Pension Fund X are obliged to act in the best financial interests of the members when making investment decisions. Accordingly, risks associated with climate change can only properly be taken into account to the extent that they carry detrimental financial implications.

24. It is our opinion that the position in common law is sufficiently clear that it is not reasonably open to challenge. Further, and also of relevance to the discussion below, we are of the clear view that if the trustees are made aware of something that gives rise to a material financial risk (including any ESG factor that gives rise to a material financial risk) then not only can they take that into account when making investment decisions but they are obliged to do so; in other words, they can and must take it into account.

25. We now examine whether this common law obligation is to any extent overridden by any of the applicable statutory provisions.
The key legislative provisions in relation to investment powers are sections 33 to 36 of PA95 and the Occupational Pension Schemes (Investment) Regulations 2005 (the ‘Regulations’).

Section 33 of PA95 precludes trustees from excluding or restricting their liability in relation to investment functions. This is one of the principal reasons why trustees typically choose to take advantage of section 34 which permits trustees (subject to any restriction in the trust) to delegate their investment functions to a fund manager, in which case liability will only attach to the trustees in situations where they failed to take reasonable steps to satisfy themselves that the fund manager had appropriate knowledge and experience, was carrying out his work competently and was complying with the requirements of section 36\(^\text{11}\).

Section 36 of PA95 imposes various obligations on the trustees (or the fund manager where investment functions have been delegated):

(a) The trustees and fund manager must exercise their investment functions in accordance with the Regulations (section 36(1));

(b) Before investing in any manner, the trustees must take proper advice (section 36(3));

(c) When deciding to retain an investment the trustees must take proper advice at appropriate intervals (section 36(4));

(d) The trustees or the fund manager must exercise their powers of investment with a view to giving effect to the SIP so far as is reasonably practicable (section 36(5)).

The Regulations impose a number of further obligations, including the following:

(a) Pursuant to section 35 of PA95 the trustees must prepare a SIP. Regulation 2(1) requires them to review the SIP at least every three

\(^{11}\) See section 34(4) of PA95.
years but immediately if there is any significant change in investment policy;

(b) The trustees must take appropriate advice before preparing or revising the SIP (Regulation 2(2));

(c) At Regulation 2(3) there is a list of matters that must be included in the SIP; in particular Regulation 2(3)(b) says that the SIP must specify:

‘their policies in relation to –
(i) the kinds of investments to be held;
(ii) the balance between different kinds of investments;
(iii) risks, including the ways in which risks are to be measured and managed;
(iv) the expected return on investments;
(v) the realisation of investments; and
(vi) the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments.’

30. Pursuant to Regulation 4 the trustees (or fund manager) must exercise their investment functions as follows\(^\text{12}\):

(a) assets must be invested in the best interests of the beneficiaries (Regulation 4(2));

(b) investment powers must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole (Regulation 4(3));

(c) assets held to cover the scheme’s technical provisions must be invested in a manner appropriate to the nature and duration of expected future benefits payable under the scheme (Regulation 4(4));

(d) assets must be properly diversified so as to avoid excessive reliance on any particular asset and to avoid accumulation of risk in the portfolio as a whole (Regulation 4(7)).

31. On the clear face of the above legislation, the trustees’ obligation (absent any delegation to a fund manager) is to invest in the best interests, ie financial interests, of the members and this does not, in our opinion, take us materially further than the position at common law set out in Cowan and Stena as

\(^{12}\) It is worth noting that the full requirements of Regulation 4 are disapplied in respect of schemes with fewer than 100 members (Regulation 7); this may be relevant if selecting a scheme for the purpose of legal proceedings.
discussed above. We note in this context the clear indication that the statutory regime does not require ESG factors that do not give rise to a financially material risk to be taken into account when making investment decisions (given the presence of the words ‘if at all’ in Regulation 2(3)(b)(vi)).

32. However, in our hypothetical scenario involving Pension Fund X, the trustees of the Fund have delegated their investment decisions to a fund manager. This is entirely typical and reflects two practical matters. The first, as noted above, is that without a fund manager the trustees might be exposed to claims for breach of investment obligations that cannot be excluded or restricted unless delegated to an appropriate fund manager.

33. The second point is that in order to make investments on a routine basis the trustees would have to be authorised within the meaning of the Financial Services and Markets Act 2000 (‘FSMA’), as such activities will fall within the definition of ‘regulated activity’. The Perimeter Guidance Manual (‘PERG’) (part of the FCA Handbook) sets out what is and what is not a regulated activity. Questions 8 and 9 of PERG 10.3 make it clear that trustees can make certain high level strategic decisions without authorisation, such as preparation or revision of the SIP or formulating a general asset allocation policy and also certain decisions that need to be taken in exceptional circumstances, such as investment decisions that raise sensitive policy considerations ‘such as investments in certain territories or markets or in ethical or green areas’. What the trustees cannot do without authorisation is make day-to-day decisions, ie decisions to buy and sell particular investments or seek to direct their fund manager to do the same; such day-to-day decisions are regulated activities.

34. To summarise, the relevant statutory provisions (in particular those of PA95 and the Regulations) impose a number of obligations on trustees and/or on fund managers to whom investment decisions have been delegated. In our hypothetical scenario, the trustees have delegated day-to-day investment decisions to a fund manager but have retained responsibility for making strategic decisions. Nevertheless, when making strategic decisions the trustees must act in the best financial interests of the scheme members.

---

13 And it is worth noting that conducting a regulated activity without authorisation is a criminal offence (see section 19 of FSMA).
However, that does not mean that they must make decisions aimed at maximum short-term profit. They (and/or their fund manager) must take into account such matters as the duration of expected future benefits payable under the scheme (ie not simply maximising short-term returns to the detriment of long-term performance if benefits will have to be paid over the long term) and the need for suitable diversification (ie not putting all of the scheme’s eggs in one basket). Those matters form part of the considerations relevant to the financial interests of the scheme membership as a whole. In other words, what is in the members’ best financial interest is a question of balancing return against risk and for any particular scheme that will depend on a number of factors specific to that scheme, such as the age profile of the membership. What is also clear, in our opinion, is that the trustees are only permitted to take ESG factors into account to the extent that they give rise to material financial risk to the benefits to be paid to members (subject to the exceptions we have referred to at paragraph 21 above), although again that risk need not necessarily be to short term returns. On that basis, the obligations imposed on trustees under the applicable statutory regime seem to us to be consistent with the common law duties discussed in the previous section of this Opinion; it all comes back to the best financial interests of the members albeit that involves a more subtle concept than simply maximising short term returns.

The Law – the Law Commission Report / Government Consultation / tPR

35. We should say something briefly here about the views of the Law Commission, the result of recent Government consultation on possible amendments to the Regulations and even more recent guidance from the Pensions Regulator (‘tPR’). None of these is inconsistent with the views we have expressed above, but they do give considerable support that those views are correct.

36. The Law Commission has produced a report (No 350) titled ‘Fiduciary Duties of Investment Intermediaries’ (the ‘Report’)

14 See also the Law Commission guidance note, “IS IT ALWAYS ABOUT THE MONEY?” Pension trustees’ duties when setting an investment strategy’, which contains a relatively short summary of the views expressed in the Report.
Chapter 6, a discussion of the legal obligations on pension scheme trustees when taking investment decisions.

37. The contents of the Report seem to us to accord with the views we have expressed in the previous sections of this Opinion. The obligation on trustees is, in essence, to act in the best financial interests of members, but that is a matter of balancing risk against return in the long term rather than seeking to maximise short term returns.

38. We note and agree with the suggestion in the Report that referring to ESG factors is not particularly helpful. A factor may be seen as an ESG factor, but may nevertheless be financially material and therefore something that trustees can and must take into account when making investment decisions. Conversely, there may be non-ESG factors that are not financially material. We agree that a more useful distinction is between financial and non-financial factors.

39. In light of the Report, the Government launched a consultation in February 2015 as to possible amendments to the Regulations, including to Regulation 2 to make a clearer distinction between financial and non-financial factors. To the surprise of many, the Government’s response to the consultation, published in November 2015, was to the effect that there was no consensus between consultees as to how further clarity would best be achieved, and so no amendment would be made at all. The response also said that the publication of the Report itself had already provided greater clarity, that tPR was updating its DC guidance in light of the Report and that there was evidence of greater awareness on the part of trustees of their duty to consider ESG factors which may be financially material to scheme performance.\(^\text{15}\)

40. Therefore, although the Government has declined to amend the Regulations to make clear that factors, whether ESG or not, can and must be taken into account if they are material financially to a scheme, the Government’s response to the consultation together with the content of the Report strongly support the contention that that is the correct formulation of the legal duty on trustees.

\(^{15}\) Although the extent of this evidence is unclear from the Response to Consultation, and it appears to be inconsistent with ClientEarth’s understanding of the current position.
41. This is also supported by guidance issued by tPR. In tPR’s Code of Practice No. 13 dated 11 July 2013 (and therefore published before the Report), it is said (at ¶134), by reference to Regulation 2(3) of the Regulations, that:

‘In acting in the best interests of members and beneficiaries, trustees should take financial interests into account. They must also set out in their statement of investment principles the extent (if at all) to which they have considered issues such as socially responsible investment (for example social, environmental and governance factors) that may affect the long-term performance of investments.’

42. It is of note that the above extract refers to ESG factors that may affect long term investment performance. This goes further than the wording of Regulation 2(3) itself, but is consistent with the interpretation of trustees’ duties outlined above, ie that any financially material factor, whether ESG or not, should be taken into account.

43. Further guidance, ‘A Guide to Investment Governance’, was issued by tPR in April 2016. This refers (at page 13) to the Report and confirms that trustees should take in account any factors, whether or not ESG, which are financially material to the performance of investments. Also of interest to the current discussion, the guidance says this (also at page 13):

‘You should bear in mind that most investments in DC schemes are long term and are therefore exposed to the longer-term financial risks. These potentially include risks relating to factors such as climate change … These risks could be financially significant, both over the short and longer term. You should therefore decide how relevant these factors are as part of your investment risk assessment. … Once you have considered the longer-term sustainability of your investments, you may wish to take action. …’

44. It seems to us that the latest tPR guidance is helpful in at least two ways. First, it supports the view that the legal obligation on trustees extends to a requirement to take into account any financially material factor when making investment decisions. Second, it raises climate change expressly as giving rise to a potential financial risk to be taken into account in this context.
45. We note for completeness that both the Report and tPR’s guidance envisage that there may be circumstances in which ESG factors which are not financially material may be taken into account, for example where there is good reason to think that all of the scheme members share a view about the factor and there is no risk of significant financial detriment to the scheme if the factor is taken into account. In outline terms this seems to us to be broadly consistent with the exceptions contemplated in Cowan and Harries as discussed above. However, the hypothetical scenario we have been asked to consider does not envisage taking into account a factor that is not financially material, and so we do not propose to discuss this matter further here.

46. Finally, we note a matter from the Report to which we will return later. At ¶6.10 it is said that, within the broad parameters laid down by the law, trustees must exercise their own discretion when making decisions and, in so doing, ‘There are no right answers’. We will come back to this point in the discussion below, but it is important to recognise that when making decisions concerning investment the trustees of a pension scheme are exercising a discretion; faced with the same information different trustees may reach different decisions but as long as they have acted reasonably and taken account of all relevant and no irrelevant matters then their decisions are unlikely to be susceptible to challenge.

The law – discussion and conclusions

47. Before addressing the specific question raised in our instructions, we think it helpful to summarise the legal position as discussed above in the context of our hypothetical Pension Fund X.

48. The starting point is that the purpose of Pension Fund X is to provide pensions to its members (and their dependants). Accordingly, in exercising their investment powers the trustees should have regard only to the members’ financial best interests. Any factor that is financially material can and must be taken into account, whether or not it would ordinarily be described as an ESG factor. There may be some exceptions such that factors that are not material financially may be taken into account in some circumstances, but we do not think that any such exception applies on the (hypothetical) facts of this case.
49. On that basis the trustees of Pension Fund X can, and must, take risks associated with climate change into account when exercising their investment powers to the extent that those risks carry material financial implications for the performance of the Fund. It should be remembered that material financial risk in this context does not mean that it would necessarily have an immediate impact on investment return. It may include longer term financial consequences. However, it must give rise to some material financial risk.

50. How, it may be asked, do the trustees assess whether a factor is financially material? One point to note is that the trustees are obliged to obtain expert financial advice before preparing or revising the SIP (see Regulation 2(2)(a) of the Regulations). It is difficult (and undesirable) in our opinion to attempt to formulate any rigid approach to determining whether a particular factor, such as climate change, will or will not give rise to a financially material risk; what is and what is not financially material is likely to be highly fact sensitive.

51. Having said that, the correct approach for trustees is, in our view, no different to the duty prescribed by the common law that trustees should ‘take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide’\(^\text{16}\).

52. Of course, just because an investment carries a material financial risk such that the trustees must take that risk into account, that does not mean that the trustees (or fund manager) should not ultimately select that investment. All competing relevant factors should be weighed, balancing risk against return, before an investment decision is made. As long as all financially material risks are taken into account then an investment may be selected even if it involves risks, including those associated with climate change, providing that the decision to invest could not be described as unreasonable or perverse\(^\text{17}\). It is important to recognise that two trustee boards may reach different decisions based on consideration of the same factors, one deciding not to

\(^{16}\) In re Whiteley (1886) 33 Ch D 347.

\(^{17}\) See, for example, Harris v Lord Shuttleworth [1994] ICR 991: as long as all relevant factors and no irrelevant factors are taken into account and the ultimate decision is not perverse or unreasonable (in a Wednesbury sense), then an exercise of trustee discretion will not be susceptible to successful challenge.
invest and the other deciding to invest in spite of identified risks, but neither may be acting unreasonably in doing so. The important thing is that they have taken all financially material risks into account in reaching that decision.

53. We now turn to the address what we consider the correct approach to be to the hypothetical scenario set out above.

The Hypothetical Scenario – The correct approach

54. Although we acknowledge that few, if any, trustee bodies are likely expressly to approach the matter in this sub-divided way, it seems to us that when properly analysed the decision-making process for trustees considering investment risks (including those associated with climate change) essentially involves three steps:

(a) Step 1 is to decide what matters, if any, give rise to a financially material risk to the scheme in question and, in particular in this context, whether those matters include climate change;

(b) If those matters do not include climate change, then it is not a factor that can be taken into account, but if they do then Step 2 requires the trustees to take that factor into account; it is our opinion that the law clearly permits and requires the trustees to take into account any financially material factor (including climate change, if the trustees, after following Step 1, decide that it is financially material);

(c) Having taken the financially material factor into account, Step 3 would involve the trustees deciding what, if any, action to take in light of that factor, whether it be in terms of deciding whether or not to include it in the SIP or deciding to take some other action.

18 And again it must be remembered that the duty is for the trustees to exercise their judgment with the degree of care of the ordinary prudent man in the particular context in which they are making that decision (see ¶12 above); there will be no absolute right or wrong answer and different trustees may reach different conclusions yet both be complying with their duty.

19 The context including, we think, that climate change is ‘on the table’ with regard to the particular investment decision the trustees are considering, ie it has been raised with the trustees either by one of their number or by a third party as giving rise to a potentially financially material risk.
55. If the risks associated with climate change are financially material to a particular investment decision then it is clear, we think, beyond reasonable argument that the law permits and requires the trustees to take those risks into account when making that investment decision.

56. As to what action the trustees can and should take if they have decided that climate change is financially material, and that they should take it into account with regard to a particular investment decision, we have reached the clear opinion that what decision the trustees then take as to further action is a matter within their discretion.

57. The remaining piece of the jigsaw concerns the first step outlined above, ie a decision as to what matters, if any, give rise to a financially material risk to Pension Fund X and, in particular, whether those matters include climate change. We think that the decision by trustees as to whether a particular factor gives rise to a financially material risk to a scheme is essentially a matter within the judgment of the trustees, looking through the lens of the ‘ordinary prudent man’.

58. There is one remaining matter that we think should be considered here. We note from the responses to member queries (the gist of some of which ClientEarth has shared with us) that some trustees have taken the position that climate change is ‘merely an ethical/moral or … ESG … concern, with little or no bearing on investment returns.’ This could, we think, mean one of two things. First, it could mean that trustees have turned their minds to climate change risk and have concluded that it is not financially material. On the other hand, it could mean that trustees have simply refused to turn their minds to the question of financial materiality on the basis that they consider it inconceivable that ESG factors in general, or climate change in particular, could ever be financially material.

59. We also note from our instructions that the hypothetical scenario envisages that the ‘other trustees’, ie not the concerned trustee, are not sure whether they are able to take climate change into account ‘as it has moral and ethical implications.’ It is not entirely clear, but this might suggest that the trustees of Pension Fund X (other than the concerned trustee) take the view that because they think climate change is an ESG factor it simply cannot be taken
into account. In other words, they have not turned their minds to the question of whether, even if it is an ESG factor, it is financially material.

60. If that is the scenario envisaged then we think that is something that could form the basis for a successful legal challenge. The essential point would be that trustees are obliged to take into account financially material factors and they are therefore effectively obliged, when a matter is raised with them that is not obviously fanciful, to turn their minds to whether it is financially material. If they simply refuse to do so, whether because they consider that an ESG factor cannot ever be financially material or for some other reason, then that, we think, would not be a proper exercise of their powers and would be open to challenge.

Conclusion

61. We trust that the above satisfactorily answers the issues on which we have been asked to advise, but if those instructing us wish to discuss anything further then they should not hesitate to contact us in Chambers.

KEITH BRYANT QC
JAMES RICKARDS
25 November 2016

Outer Temple Chambers
222 Strand
London WC2R 1BA

20 Some minor amendments to some wording in the text of this Opinion were made in April 2017 but no changes have been made to the substance of the opinion given.