

SUFFOLK PENSION FUND: INVESTMENT IN TOBACCO COMPANIESFURTHER OPINION

1. I am instructed to advise Suffolk County Council (“the Council”) in its capacity as an administering authority for the purposes of the Local Government Pension Scheme (“LGPS”). On 23 January 2015 I provided the Council with an Opinion in which I discussed the lawfulness or otherwise of a potential decision to disinvest its pension fund from tobacco interests. I am now asked whether the legal position has altered in any material respect since my original Opinion.
2. The view set out in my original Opinion was that it was legitimate for wider social and ethical considerations to be taken into account in reaching investment decisions, but only where that would not risk causing significant or material financial detriment to the fund. I agreed with the statement in a Law Commission paper, that the aim must be to achieve the best realistic return over the long-term. On the facts, I concluded that if the Council based its decision-making upon the advice that it had then received from its investment managers, then the effect of that advice was that disinvestment from the tobacco sector would risk material financial detriment, in terms of its impact both upon risk/volatility and upon return, and would therefore be unlawful.
3. The relevant legal framework has recently changed, although the substantive position is not much different to what it was when I previously advised. On 1 November 2016 the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 came into force. By r.7(1), an administering authority is required, after taking proper advice, to formulate an investment strategy, which must include *inter alia* the authority’s policy on how social, environmental and corporate governance

considerations are taken into account in the selection, non-selection, retention and realisation of investments. The important new development is that such a strategy must be in accordance with guidance issued from time to time by the Secretary of State<sup>1</sup>. Since the administering authority is discharging statutory functions, it is my view that it is the guidance that now governs these matters, rather than any broader concepts of fiduciary duty (although of course, as the issued guidance recognises, decisions taken by an administering authority must accord with ordinary public law principles, including *Wednesbury* reasonableness).

4. The guidance was issued in September 2016. It contains some particular provisions about matters relating to foreign and defence policy, but I shall ignore those because they are irrelevant to the tobacco issue. There are two relevant statements in the guidance (with emphasis supplied):

- (i) That schemes should consider any factors that are *financially* material to the performance of their investments, including social, environmental and corporate governance factors; and
- (ii) “Although schemes should make the pursuit of a financial return their predominant concern, they may also take purely *non-financial* considerations into account provided that doing so would not involve significant risk of financial detriment to the scheme and where they have good reason to think that scheme members would support their decision.”

5. Both those statements are similar in effect to what I had previously advised to be the existing law. There are two possible differences. First, my advice was that decision-making by reference to non-financial considerations

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<sup>1</sup> Mandatory compliance is normally antithetical to the concept of guidance properly so-called. However, it is clearly what r.7(1) of the Regulations calls for, and in circumstances where the Secretary of State’s powers to make scheme regulations under the Public Service Pensions Act 2013 are very broad, and include powers to give directions as well as guidance, I do not think that r.7(1) is *ultra vires*.

should not risk causing significant or material financial detriment. The guidance speaks rather of significant risk of financial detriment. So, the word "significant" is used in the guidance to qualify the extent of the risk rather than the extent of the detriment. On the one hand, this indicates that there needs to be a real and not merely a remote chance of such detriment before the authority need feel inhibited by it. On the other hand, it suggests that where there is such a risk, the authority ought not to run it even though the resulting detriment would not be very large. I think that it must nonetheless be implicit that the potential financial detriment would have to be material, and not trivial. But under this guidance the bar is not being set high, so far as what would constitute an unacceptable detriment is concerned.

6. Secondly, my previous advice proceeded on the basis that it was really for the administering authority to make its own judgments about what was socially or environmentally desirable, within the limits of *Wednesbury* reasonableness. Members' likely views would no doubt have been a *Wednesbury* relevant consideration, but no more than that, and I did not regard it as necessary specifically to seek to identify those views before coming to a decision. Under the guidance, however, it is clear that non-financial considerations may only be taken into account where the authority has "good reason to think that scheme members would support their decision". Additionally, it is to be noted that the guidance says that the investment strategy should:

"explain the extent to which the views of their local pension board and other interested parties who they consider may have an interest will be taken into account when making an investment decision based on non-financial factors."

7. There remains a duty, under r.7(5) of the Regulations, for the authority to consult "such persons as it considers appropriate" as to the proposed contents of its investment strategy. The most obvious, although not necessarily the only, way of establishing whether scheme members would

support a decision to take account of non-financial considerations, by for example tobacco disinvestment, would be to include them amongst the r.7(5) consultees.

8. The current position is thus in summary as follows. Tobacco disinvestment would be lawful if it was thought to be desirable on purely financial grounds. It would also be lawful if prompted by social considerations, provided that two conditions were met: first, that there was no significant risk of financial detriment; and secondly, that there was good reason to think that scheme members would support the decision.
9. Had the present Regulations and guidance been in force when I previously advised, they would not have changed my advice. The Council was not suggesting that there were financial reasons for disinvesting from tobacco, and on the basis of the investment advice then received, there would have been a significant risk that doing so would lead to financial detriment.
10. I have also been supplied with an e-mail setting out comments received (recently, I presume) from two of the managers of segregated funds with which the Council invests, and the manager of one of its pooled funds. They represent three of the four fund managers whose then advice was addressed in paragraph 9 of my previous Opinion. The comments are really directed towards their reasons for continuing to invest in tobacco stocks, rather than any direct assessment of the risk of financial detriment if the Council pursued a policy of disinvestment. However, it is reasonably clear that Newton is saying that disinvestment would risk financial detriment ("finding alternative stocks would not be straightforward and may impact on the risk/return outcomes"). Although Newton does not quantify the extent of the risk intended to be conveyed by the words "may impact", reading its comments as a whole gives the strong impression that it would regard that risk as significant. Blackrock says that portfolios not permitted to hold tobacco shares "typically" have "slightly less attractive revenue stability and/or growth characteristics". The word "typically" must connote

significant risk, and although it is unclear what “slightly less attractive” is intended to convey in terms of the extent of the impact, it sounds as though Blackrock thinks it would be material. The effect of Pырford’s advice is less clear, but the references to the historically exceptionally good performance of tobacco stocks, coupled with the reference to them not being easy to substitute, suggests to me that it would also perceive a significant risk of material financial detriment from disinvestment. None of the comments suggest that there would currently be legitimate financial reasons for pursuing a policy of tobacco disinvestment.

11. It would be open to the Council to ask its fund managers more directly whether tobacco disinvestment carried a significant risk of material financial detriment, and it would of course be open to it to seek further advice from other quarters. However, on the basis that this is the current advice (and of course the investment strategy has to be formulated after taking proper advice), it seems to me clear that the Council would not be acting in accordance with the guidance if it adopted a policy of disinvestment (even leaving aside the requirement for member support). I do not think that the Council is obliged to seek further or alternative advice, assuming that there is no reason to doubt the reliability of the advice it has already been given, although there might be a need to reconsider this if the consultation on the investment strategy revealed strong member support for investigating disinvestment further.

## CONCLUSIONS

12. The effect of the new Regulations and guidance is in summary as follows. Tobacco disinvestment would be lawful if it was thought to be desirable on purely financial grounds. It would also be lawful if prompted by social considerations, provided that two conditions were met: first, that there was no significant risk of financial detriment; and secondly, that there was good reason to think that scheme members would support the decision.

13. On the basis of current advice, the Council could not lawfully disinvest from tobacco stocks. The advice does not suggest that there would be any financial grounds for disinvestment, and it does suggest (albeit not absolutely explicitly) that to do so would carry a significant risk of financial detriment. One does not therefore reach the issue of member support. It is for the Council to consider whether it wishes to seek any further advice, *inter alia* in the light of consultation on its investment strategy.

14. My Instructing Solicitor should not hesitate to contact me if I can assist further.

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7 November 2016

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THE SUFFOLK PENSION FUND

AND IN THE MATTER OF  
INVESTMENT IN TOBACCO  
COMPANIES

FURTHER OPINION

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