Opinion of Christopher McCall QC on Ethically Questionable Investments: A Summary for Trustees

Introduction

Bates Wells & Braithwaite London LLP ("BWB"), a firm of solicitors, decided, on its own account, to instruct Mr Christopher McCall QC to give a written Opinion on the subject of ethically questionable investments. Counsel was asked to give specific reference in his Opinion to the place of so-called 'carbon intensive assets', including fossil fuels such as coal, oil and gas ("CIA").

Whilst Counsel's duty is to BWB alone, Counsel has agreed that his Opinion may be published for general consumption, given the importance of the issues the Opinion raises for charity trustees and other fiduciaries. Counsel provided his Opinion on 16 November 2015. This summary is intended to assist trustees and other fiduciaries to understand the key conclusions set out in the Opinion.

Securing a Financial Return

In general, investment is a word which denotes the intent to secure a financial return and the starting point when investing is to seek to find the best financial returns in the market, whilst having regard to the need to manage risk. Diversification brings with it a ready means to manage the risk of underperformance in one or more parts of a portfolio by reducing dependence on one or more asset classes and so caution should be exercised before reducing the scope for diversification.

It may be argued that a type of investment which is socially costly, such as CIA, may be financially disadvantageous because of a supposed element of mispricing in the market or a concern that market appetite may decline or a fear that regulatory burdens may be imposed in the future which will render any such investment positively disadvantageous. It is for trustees to determine, on the basis of financial advice, whether such concerns and fears are well placed in the case of CIA or otherwise.

The potential financial risks attaching to CIA, if well founded, are of such a nature and magnitude that they should at least be considered and assessed by any prudent trustee or fiduciary. Of course, it is for trustees and other fiduciaries to determine what is significant or material in the context of their own particular trust and in particular to form a view, with the benefit of advice, as to how far they can or ought properly to limit their scope for diversification with respect to CIA or otherwise.

Conflict with Charitable Objects

In the case of a charity, where a certain type of investment might reasonably be expected to be inconsistent with the objects of the charity, then it must be ruled out of consideration regardless of the financial consequences. In some cases, this inconsistency or conflict will be 'patent' or self-evident.

It is for charity trustees to determine whether there is a link between the specific purposes of a charity and the dangers posed by the investments concerned, such as in the case of CIA, in view of the prevailing evidence. The Opinion suggests that it is at least arguable that investment in CIAs could be said to be irreconcilable with the intent behind charities with:

- general or specific environmental purposes;
- general health purposes;
- general poverty purposes;
- other purposes relating to matters where the properties of CIAs and the consequences of dangerous climate change are of particular concern.

Alienation of Supporters or Beneficiaries

In the case of a charity, where a certain type of investment, such as CIA, might reasonably be expected to alienate supporters or beneficiaries or the work of the charity may otherwise be impeded by the relevant investment and there are no financial reasons (whether in terms of diversification or otherwise) which justify making the type of investment in question, then this situation might be described as a 'latent' conflict and charity trustees should disregard the type of investment.

Other Grounds for Ethical Investment

In the case of a charity, there may be situations where there is no clear conflict, whether patent or latent, with a certain type of investment but nonetheless an ethical investment policy may be pursued:

- where it is arguable that a conflict arises, though it is a matter of subjective opinion whether it does or not, but there is no financial detriment in giving effect to an ethical policy;
- where it is clear that charitable moneys should not be used to support what is on analysis an anti-social enterprise amounting to an "evil or tainted source", such as might be argued to be the case, for example, with respect to pornography; and

- investments are not suited to the investment of charitable moneys because in the reasonable opinion of the trustees they risk forms of harm which are not in the public interest and those forms of harm are not outweighed by financial advantages, such as might be argued with respect to CIA should trustees reasonably come to the view that there is not likely to be any material difference in financial performance between investment strategies where CIA are included and those where CIA are excluded.

Bates Wells Braithwaite

16 November 2015

Approved
CHL
16.xi.15

THE POWERS AND DUTIES OF CHARITY TRUSTEES AS TO ETHICALLY QUESTIONABLE INVESTMENTS WITH SPECIFIC REFERENCE TO CARBON INTENSIVE ASSETS

OPINION
(November 2015)

Bates Wells & Braithwaite London LLP

Note:

Bates Wells & Braithwaite London LLP ("BWB"), a firm of solicitors, decided, on its own account, to instruct Mr Christopher McCall QC to give a written Opinion on the subject of ethically questionable investments. Counsel was asked to give specific reference in his Opinion to the place of so-called 'carbon intensive assets', including fossil fuels such as coal, oil and gas. Whilst Counsel makes clear his duty is to BWB alone, he has agreed that the firm may publish it for general consumption.

1. In this Opinion (which is written for the benefit of Bates Wells & Braithwaite London LLP, and in respect of which I can thus accept no duty of care to third parties, though I recognize that it may be published to others) I have to consider whether trustees of charities (or the directors of charitable companies) should or may eschew certain forms of investment on the grounds that on a true analysis:

(i) they involve what have been historically underappreciated financial or other risks to the charities concerned; and/or

(ii) should be ruled out of contention for a given charity's portfolio on the grounds that it would be for the public benefit or otherwise ethically appropriate so to do.

2. I shall in giving my advice use the acronym "CIA" to denote what trustees may regard as carbon intensive assets (though this is not a phrase with any precise meaning and may well transmute with advances in scientific understanding); it may be thought to denote the most obvious asset class investment in which would now be open to question by investors with a strong sense of environmental social responsibility. Examples of CIAs would include shares in companies operating to extract coal, oil, gas and other forms of fossil fuels. I should say that my understanding is that my Instructing Solicitors regard CIAs as a case of particular significance because it is one in which there is room to think that the relevant financial considerations may be not fully understood and thus not fully priced into the market, in which case it is particularly important that charity trustees should inform themselves of the issues. I then use the acronym "SCA" to denote what I would refer to as socially costly assets; this usage seeks to denote those assets which might be thought objectionable to investors because they have to a greater or lesser degree a demonstrable health, environmental, or other social cost (the use of low cost labour might be thought to be one such “other” cost) not accurately priced into the market and/or the ethical status of

which may be open to objection so that once again the mix of financial and ethical objections call for attention. Examples of SCAs would include investment in companies producing or selling alcohol, tobacco or arms or engaging in what may be regarded as usurious lending practices. It is important to bear in mind that such assets may with the passage of time come to be seen as requiring the social cost to be taken into account by the imposition of licence fees or burdens of special taxation (or in the case of low labour cost enterprises by the probability that production costs will rise under societal pressure), so that they may be thought to be pregnant with material financial risk. They may also face the risk that market appetite for such investments may decline as the years go by. Finally I use the acronym "EDA" to denote ethically debatable assets, meaning those assets investment in which might be perceived to be open to ethical objection, even if no direct societal cost can be identified; the most striking example emerging from the authorities discussed later in this Opinion is the case of the reluctance of the Church Commissioners to invest in media assets, for fear (it seems) that they might be seen to seek a profit from companies which could be expected to adopt political points of view, something which was felt to be inconsistent with the non political stance of the Church Commissioners. Precisely because these are debatable (plainly not every charity would take objection to media investments) it is for individual charity trustees to determine what it is in any particular case that may require consideration; but a possible example might be investment in an undertaking relying heavily on genetically modified seeds on the part of a charity dedicated to the preservation of the countryside.

3. I pause to point out that CIAs will fall within the class of SCAs but not vice versa; EDAs are a different category of asset in that what is objectionable is a matter of ethics alone and not one of societal or environmental cost.

4. I use the phrase "socially costly assets" because I envisage that assets within this characterization will all involve costs or potential costs impinging on society which can be expected in tum to impinge on the value of the assets in question. If I invest in an asset which involves a material cost for society (as is the financial thesis underlying modern concerns about investing in CIAs) the risk of regulation of the asset must be fully priced into the market at the time of investment if I am not to risk overpaying for the asset by reference to its market value (or, and it is of course the other side of the same coin, making a loss on divestment). If I invest in an activity which may require licensing or burdens of specific tax or duties or other regulation to permit government to offset a real or perceived social cost, I will wish to be reassured that the potential cost of such licences or duties or other regulation has (as best it can be done) been priced into the market so as not to risk overpayment. But it is important to stress that the risk of overpayment is the same for any investor and does not involve special considerations for charity trustees; to the extent that the risk of overpayment is material, it is a matter properly for the consideration also of trustees of private trusts, pension funds or any person charged with investment responsibilities on behalf of others. For that reason it will be apparent that it will be hard to justify the exclusion by charity trustees of CIAs or other categories of asset from the range of assets open to them unless either it is possible to combine any financial doubts with what the charity trustees consider to be relevant social or environmental doubts as well, or investors at large might be advised to regard CIAs (or the relevant class of assets) as requiring reconsideration because of hitherto unperceived or underappreciated financial risks. Obviously no investor will buy what he thinks to be overpriced, but that concern will not arise out of (or be exacerbated by) the status of the investor as a fiduciary as opposed to an individual, save in so far as the fiduciary has to observe the general rules of prudential

management of his funds and properly consider and manage material financial risks1 (and in the case of charity trustees must have regard to the applicable statutory framework) whereas an individual investor can take whatever risks he may think fit. (For the prevention of doubt I stress that I do not mean to imply that financial reasons can justify charity trustees in abandoning an asset class only if and when other investors do so; on the contrary they may be wise to move while the market has not marked down the value of the assets in question because the risks are not generally appreciated; the point I seek to make is simply that the advice whether or not an asset is mispriced will not depend on the status of the investor.)

5. It will be seen from what I have said above that the species of objection which might be taken to these various classes of asset as suitable investments for charity range from the purely ethical (or indeed the purely financial) to those in which the ethical, the social and the financial all interplay. This will emerge as a most important factor in the following analysis. As the law now stands the financial aspects of an investment stand on a very different footing from those of ethical, social and environmental considerations. Without hesitation I would however stress that it seems to me that these financial and non-financial types of objection cannot be kept entirely separate the one from the other, because as indicated above, a growing sense of principled objection may be reflected in an SCA becoming taxed, subject to licences or other permissions or regulated, and its financial value may reduce as a result.

6. In addressing the question how far should (or may) charity trustees (in the statutory sense of that phrase, which does of course include the directors of charitable companies) decline to invest in CIAs SCAs, or EDAs, there is both statutory law (including subordinate

[1] By my use of the word "material", I seek to indicate considerations material to a trustee in the sense that they would be rightly taken into account by a prudent man of business tasked with responsibility for the property of others.

legislation) and case law to be taken into account, as well as what at the moment would seem likely to be imminent developments in statutory law.

Statute

7. Trustees have a statutory duty of care in relation to their investment policies - Trustee Act 2000 sections 1 and 2. They must under section 4 have regard to standard investment criteria namely:

(a) the "suitability" to the trust of investments of any particular kind, and of specific investments as investments within that category; and

(b) the need for diversification.

In principle, charity trustees should seek advice about matters of investment (unless there is reason to conclude that it is not necessary to do so); see section 5(1) of the Trustees Act 2000. They can delegate their investment discretions, but if so must make sure that there is in place for the guidance of their delegates a policy statement (section 15 of the Trustees Act 2000), and they must keep their delegates' acts under review (section 22 of the Trustees Act 2000).

8. I should add that although those whom the Charities Act 2011 denotes as charity trustees include persons who are not trustees in the strict sense but who are directors of charitable companies, and who are not as such subject to the Trustee Act 2000, I see no reason to doubt that they are also subject, if only by inference from their fiduciary duties, to similar obligations, above all in the realms of diversification, as trustees in the strict sense.

9. But there is specific statutory provision governing the directors of a corporate charity, to be found in the Companies Act 2006. Thus all company directors have a duty to have

regard to the impact of the company's operations on the community and the environment, the desirability of the company maintaining a reputation for high standards of business conduct, and the likely consequences of any decision in the long term; Companies Act 2006 section 172. (They must also unless excepted for reasons of size provide an annual strategic report indicating how they have responded to section 172; see section 414C.) In the case of a charitable company, whilst its business and operations must denote the pursuit of its charitable objects and purposes, as opposed to the pursuit of value for shareholders, directors must still have regard to the same list of factors: section 172(2). These provisions do not alter the duties of the directors to operate their company in the best interests of their shareholders, or in the case of a charity for the advancement of their charitable purposes; in other words they do not change the law so much as emphasize that ethical considerations may well have a part, and possibly a significant part, to play in advancing the interests of the company concerned, whether charitable or not, and that it is the duty of the directors to address the question whether that is the case.

10. Similarly under the Charities (Accounts and Reports) Regulations 2008 ("the 2008 Regulations") trustees of an unincorporated charity, whose duties are not thus imposed on them by the Companies Act 2006, must include in the charity trustees' report a description of the policies (if any) which have been adopted for investment purposes (including in particular the extent (if any) to which social, environmental or ethical considerations are taken into account). It is clear from this that in the context of charitable trusts ethical policies are permissible in principle if so thought fit but only if justifiable in the interests of the charity. Once again this does more to confirm than to change the law; it reminds trustees of their duty to consider whether their charity requires particular policies of investment, and if so how those policies should be framed.

11. Charitable purposes must be such as to secure the public benefit; Charities Act 2011 section 2(1)(b). That requirement as it applies to individual charities goes to the purposes of the charity and the manner in which those purposes are pursued by the charity trustees, and not what might be called the administrative underpinning of the trust, in which case it would be hard to say that there was an overriding obligation to invest in a manner plainly conducive to the public benefit. I think it more appropriate to say that the public benefit requirements may be made the harder to achieve if based on an investment policy which involves public "disbenefit" (to use an unfortunate word, but one which has come to be recognized as necessary to denote potentially negative features, if any, of a charity's operations). It is not a case of balancing benefit and disbenefit; but the acceptance of a duty to pursue the charity's objects for the public benefit might well be perceived to be inconsistent with some supposed duty to invest in ways which would or might conflict with public perceptions of benefit. Can a trustee, and above all a charity trustee, properly now regard himself as under a duty when selling an asset to "gazump" if circumstances so admit? That was thought to be the old law - see Cowan v Scargill [1985] Ch 270 at page 288B; but now, for charity trustees at least, it is arguable that this no longer represents a correct reading of the law, given that so to act might not be conducive to maintaining a reputation for high standards of business conduct and might indeed damage the good name of charity as a whole. So it is not the case that the investments of charity trustees must pass some public benefit test, merely that some investments might be thought to involve a public detriment.

12. Before leaving the compendium of statutory material it is necessary also to bear in mind the Charities (Protection and Social Investment) Bill currently before Parliament. This can be expected to strengthen and confirm the legal basis on which charities may invest for ‘mixed motives’, that is to say where the aim for financial return is coupled with

(and may be tempered by) the aim to secure purposive benefit in accordance with the objects of the charity (or "mission benefit" for short). However, investment for mission benefit as well as for financial benefit does not describe the intention of trustees when engaging in ordinary investment activity, where trustees will, in principle, be intending to invest for no purpose other than the financial advantage of the charity – see paras 14 and 15 below.

Case Law

13. In Trustees of the British Museum v A-G [1984] 1WLR 418 (a case raising the issue whether the investment powers of the Museum trustees should be enlarged) there is at page 425F a fleeting reference by Megarry V-C to the fact that it is appropriate for the purposes of a charity to be taken into account in devising its investment powers, but that was no more than a perceived justification for a judicial increase in the trustees' powers of investment in equities to take account of the rising cost of artefacts such as might be required to be purchased by the trustees. It did not go to the question how such a power should be used.

14. In Cowan v Scargill (supra), however, that question arose in stark form. There, in the context of a pension trust, but applying what he presupposed to be fundamental (and indisputable) principles of the general law of trusts, Megarry V-C reached important conclusions. First he held at page 287B that a power of investment:

> "must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risk of the investments in question; and the prospects of the yield of income and capital appreciation both have to be considered in judging the return from the investment".

Secondly he said at page 287G-H that trustees:

"must put on one side their personal interests and views";

strongly held social or political views, which in the conduct of their own affairs they could take into account as they might think fit, must be left out of account in the exercise of their powers as trustees of the relevant pension trust. Thirdly, and most significantly in the ambit of my present advice, at page 288E-H he mentioned as an exception to these basic rules, but one which he assumed to be of very limited application[2] that if all the beneficiaries were:

> "adults with very strict views on moral and social matters. . .it might well not be for the "benefit" of such beneficiaries to know that they are obtaining rather larger returns under the trusts"

by reason of investments which they might be expected to regard (and the words used are plainly of exceptional strength) as being

> "evil and tainted sources".[3]

The fact that this case was a special case (not least because the Judge did not have the assistance of arguments from Counsel for Mr Scargill who chose to appear in person) does not, I think, alter the general principles set out above; but it should be borne in mind that they self-evidently do not rule out the scope for trustees who are in receipt of advice that the financial considerations applicable to each of two alternative investment strategies are essentially such that either could be justified then as a matter of discretion to make their own choice between those two alternatives on ethical grounds.

[2] see at letter H - "such cases are likely to be very rare".

[3] He did also at page 287G accept that criticism would be hard if it could be shown that trustees had acted in accordance with their principles but had made alternative investments which were equally beneficial to the beneficiaries. This exception (which might be thought not only to be a statement of the obvious but also one which tends to conflate two different aspects of investment, first the making of an investment, which is a matter of exercising a power looking to the future, and secondly the outcome of that exercise, which is a matter of looking to the past and thus infected with the wisdom of hindsight) is plainly of small comfort to trustees considering how to exercise their powers looking to the future.

15. In Harries v Church Commissioners [1992] 1WLR 1241 Nicholls V-C was asked to deal with the specific question whether it was possible to require charity trustees to reject investments on moral or ethical grounds. He concluded (as had Megarry V-C in Scargill) that investments were normally held to make money for the trust so far as consistent with the duty of prudence, and not to make moral gestures which might commend themselves to an individual holding investments on his own account - see page 1247D-F. Thus for example it was not possible to say that the Commissioners could, still less should, adopt a policy of investment relating to South Africa which would exclude them from investing in some 37% of the market by value, something which they considered would be financially disadvantageous in terms of placing excessive limits on their powers of diversification (even though they had already policies in place, which the Judge did not seek to criticize, excluding them on ethical grounds from 13% of the market).

16. Nicholls V-C did recognize (at page 1246F-H) that it would be right for charity trustees who could legitimately regard a particular species of investment as conflicting with the objects of their charity to reject any such investment, regardless of the financial consequences; he referred to:

> "much-cited examples such as cancer research [charities] and tobacco shares",

and also referred to the case of trustees of temperance charities and Quaker charities which might be expected to exclude respectively shares in breweries or companies engaged in the armament business. In so doing, though he did not actually refer to the fact, it seems that he was developing a line of thinking which has some parallels with the exception which Megarry V-C had indicated in Scargill as to “tainted sources" but it could equally well be said that he was recognizing that a purpose trust cannot be expected so to invest as might make it harder for it to achieve its purposes.

17. Nicholls V-C also suggested (see page 1247A-B) that charity trustees might face a balancing exercise if (though their charity be not directed to purposes which would actually conflict with any given species of investment) it could reasonably be said that their supporters or their beneficiaries might be alienated by the making of a particular investment or the work of the charity might otherwise be impeded; it would be necessary for the trustees to compare any potential financial detriment which could be expected to flow from excluding the relevant investment from the trustees' portfolio on the one hand, and the difficulties and/or possible loss which might emerge in the pursuit of the objects of the charity from the alienation of supporters and/or beneficiaries if the trustees did so invest.

18. Finally the Vice-Chancellor held, at page 1247H, that given that there might not be any objectively right or wrong moral conclusion to be drawn in relation to the acceptability of a particular investment, charity trustees might if they thought it right so to do:

> "accommodate the views of those who consider that on moral grounds a particular investment would be in conflict with the objects of the charity *so long as the trustees are satisfied that that course would not involve a risk of significant financial detriment*".[4]

This is of course an extension of the exception outlined in paragraphs 16 and 17 above; so long as financial considerations do not militate against the relevant pattern of investment, a degree of ethical direction in the investment of charitable funds may be justified as a matter of discretion even though the moral justification for the policy in question might be a matter of opinion. It is interesting to note that this approach might be thought to reflect the comments of Cross J in in re Snowden [1970] Ch 700 to the effect that a charity being founded on the recognition of moral obligations could be expected to have the power to

[4] Emphasis added.

respond to clear moral obligations, (though if to its financial detriment then only in exceptional cases – see per Cross J at page 709C-D).

19. Harries concerned the question how far a charity required ethical policies of investment. It was also concerned in practical terms with a suggested exclusion which would deny the Church Commissioners access to a much larger percentage of the market than was the effect of the policies they had felt it right to adopt and the Church Commissioners gave evidence that they would not regard a portfolio restricted to exclude 37% of the market (including 65% of the oil sector and 62% of the chemical sector) as sufficiently balanced and diversified; it could not in their view be said to satisfy the test of prudence required to ensure that their investments would be in the interests of those for whom they had to provide. Thus, the exception to the general rule which I have summarized in paragraph 17 above was not applicable (and it is also to be presumed that the Church Commissioners did not accept that the investments proposed to be excluded actually conflicted with their purposes or that the investments so impeded the work of the charity as to justify such a large measure of divestment).

Deductions

20. It is quite clear from the materials considered above that charity trustees must be very cautious before they use their property and their investment powers to make 'moral or ethical statements' unless it is necessary or permissible so to do to achieve the purposes of the charity, or financial advice renders it acceptable or desirable.

21. Charity trustees may however safely adopt an ethical approach in so far as consistent on a proper balancing judgment with the financial interests of the charity, as where to do otherwise might make it harder for the charity to satisfy its beneficiaries that their benefits were properly sourced or to satisfy its supporters that it justifies further assistance, or where

the work of the charity might otherwise be impeded. In Harries it seems that the evidence of the Commissioners' view that the policies actually proposed would render the funds insufficiently diversified was of critical importance; this shows the balancing exercise at work where a particular policy is under review. But the actual relief sought in Harries, which the Vice-Chancellor refused to grant, was general in terms, that in the management of their assets the Commissioners were obliged to have regard to the object of promoting the Christian faith through the established Church of England and might not act in a manner which some might think to be incompatible with that object, whatever the financial consequences. In sum the Court's conclusion was that such a bald statement of the duty of the Commissioners went too far. The rejection of investment returns from "evil and tainted sources", to use the words which appear in Cowan v Scargill, or from sources in conflict with the charity's purposes, to refer to the first of the exceptions to be found in Harries, would require a clear conflict before the trustees could be compelled to invest on that basis if with the benefit of proper advice they took the view (as the Commissioners did) that it would be to the financial detriment of their funds so to do.

22. But it is, I think, now arguable that, in the case of corporate charities, charity trustees are required by section 172 of the Companies Act 2006 to address the question whether they should seek to exclude investments which might be harmful to the community or to the environment, or might otherwise damage the reputation of their charity or of charity at large, or have negative consequences in the long term, above all if there is reason to think that so to do will not inflict significant financial damage on the charity; and I cannot see that the statutory provisions, though in terms limited to companies, do not cast some light also on the powers and duties of charity trustees in the strict sense under section 4 of the Trustee Act 2000 when it comes to the application of the "suitability" test. It seems to me that the 2008 Regulations bear that out and therefore that the same principles may be considered to

apply to trustees of unincorporated charitable trusts. As I have said these provisions only change the law in a very limited sense; it remains the duty of charity trustees to act in the best interests of their charity, but the statutory provisions make clear the need for the trustees to consider what if any particular policies are needed for that purpose.

23. Thus for example, in my opinion, no charity would be open to criticism if it rejected the possibility of investing in an entity making all or a significant part of its profits from pornography; it could not be said that this very limited exception would materially alter its scope for diversification, or the securing of a proper financial return from its investments, and it would plainly be both damaging to the community and to the charity's own reputation should it lend its name as a badge of respectability to an investment which could be expected to carry with it a weight of public opprobrium.

24. In sum it seems to me that, in the ordinary course, the task of justifying the pursuit of ethical policies of investment may well now be less onerous than Harries would suggest. Under Harries the scope for ethical investment was approached from what might be regarded as a negative standpoint; the question was whether the Commissioners were obliged to avoid certain types of investment which they did not think they should exclude. But section 4 of the Trustee Act 2000 and section 172 of the Companies Act 2006 have been enacted since Harries was decided, and their terms stress the positive need to consider whether (i) ethical policies of investment are required (on the part of directors of a charity under section 172), or (ii) whether trustees of a charity have special duties to test the "suitability" of particular investments to their trust. They do not change the law so much as change the emphasis. The funds of charity do in the last resort belong to the public in so far as they constitute the corpus of a public trust. Just as it can be said that ethical policies or considerations of suitability would exclude the possibility of public moneys going to

support pornography, so it can arguably be said that it would not be "suitable" to invest trust moneys so as to damage the interests of the charity or to harm the interests of the community at large.

25. Thus it seems to me that Mr Roberts of the Charity Commission was right in his published comments of 1st May 2014 on changing attitudes to ethical investment to say that things "may" have moved on since Harries and Cowan v Scargill. But it is important to note that in so saying he was giving only a very tentative opinion, and charity trustees who seek to push the taking of ethical policies beyond the ambit of the various exceptions mentioned in the cases must consider with care first whether to do so is financially justifiable and then if not what guidance they may need from the Charity Commission or the Court. Although there is of course no objection to the pursuit of ethical investment justifiable on financial grounds, it does in my view remain the fact that “moral gestures” are not in principle permissible in fiduciary investment; trust investment must, in principle, be for the financial benefit of the trust. So if they are to be able to do what cannot be justified in purely financial terms the charity trustees must be ready to show why their investment policy is nonetheless permissible on other grounds.

26. But as I have said it seems to me that modern legislation has emphasized the need to reconcile the financial interests of charity with considerations of whether its money is being put to use in ways which are not suitable to a public trust, or not to a public trust of some given character - compare re Snowden (supra).

27. Thus statute has, I think, given room to argue that there is scope and, to a certain extent, an obligation to consider the adoption of a more developed sense of social responsibility in matters of investment.

Charity trustees must always have regard to the need not to expose their funds to a material risk of financial detriment, above all the risk that is in general inherent in any substantial loss of scope to diversify; but developing thinking (such as in the case of recent thinking on climate science and the possibility of "stranded assets"[5], a matter which was not considered in Harries, though that is hardly surprising given when the case was decided) has shown that financial considerations relevant to any proper scheme of investment will involve at least the possibility of finding that there are material risks hitherto unforeseen or underappreciated, but potentially intrinsic to given species of investment. And if those risks are capable of being combined with legitimate ethical considerations then it seems unlikely that the charity trustees could be criticized for excluding such investments from consideration; and, in some cases, this may actually be required. Leaving aside for the moment the case of a charity directed to purposes which by the principle of actual conflict negate the possibility of particular forms of investment (as to which see para 35(ii) below), it seems to me strongly arguable that charity trustees may – and, in some cases, should – take a broader view of their investment responsibilities and the suitability of particular species of investment to their trust than has hitherto been thought to be the case. Even where conflict does not dictate an absolute bar to any given investment, the ethical may in appropriate circumstances be balanced against the financial; thus CIAs and SCAs will generally need financial analysis by competent advisers before charity trustees can be sure that to exclude such assets from the scope of acceptable investment would not increase the risk of doing the charity material financial harm; but if that advice is given and the purposes of the trust justify a policy that would exclude such investments then it would seem strongly

[5] For those purpose "stranded assets" broadly means "assets which suffer from unanticipated or premature write-downs, devaluations or conversion to liabilities" (Smith School of Enterprise and the Environment. 25 March 2014). The International Energy Agency in its 2013 report on Redrawing the Energy Climate Map refer to "stranded assets" in the context of fossil fuels as "investments which are made but which, at some time prior to their economic life (as assumed at the investment decision point) are no longer able to earn an economic return as a result of changes in the market and regulatory environment)".

arguable that the financial and ethical can be combined to justify – and may combine to require – a policy of exclusion. Even EDAs, though not in themselves likely to carry any evident financial cost, may well be perceived by financial advisers to be exposed to a material potential for long term risks (for example in terms of declining marketability). If so once again that factor can I think be taken into account, and if the financial advice is strong enough the Harries principles will point in the direction of exclusion.

<u>28.</u> But it is of course (as noted above) for trustees who wish to pursue policies excluding given types of investment to show that they are not putting their trust at risk; without doubt, in the absence of conflict with the purposes of the trust, the onus is on them to show that they are not guilty of making impermissible moral gestures at the expense of charitable funds. Absent conflict it is only on the basis that financial advice confirms at the very least that the exclusions will do no material long term harm to the trust that that onus can be discharged.

<u>29.</u> Nonetheless in my view there is room at the very least to put to the Charity Commission the question whether the law, together with financial projections, has not moved on since Harries so as to give rise to a need for general advice by the Charity Commission on the scope for ethical considerations to be enmeshed with perceived financial risks to allow greater elasticity in the concept of what are permissible policies for those tasked with the investment of public funds. If trustees must have regard to the possibility of investments not being suited to their trust or being potentially damaging to the reputation of their charity, there must come a point at which they can say that even equivocal financial advice, that is to say advice that leaves it open to conjecture whether their charity will be at risk of serious detriment if it excludes the investments in question, can and should be enough to allow charity trustees if in their discretion they think it right to

do so to have regard to ethical objections; if by contrast the financial case for a particular investment is not merely equivocal but points to a significant risk of financial detriment, such as may well be the case with stranded assets, then the position becomes still more clearcut. But it is for the trustees in the exercise of their discretion to determine how they should act, on the basis of appropriate advice.

30. I stress the need for advice. I must of course beware of forming views on matters outside my competence; the financial advantages and disadvantages of a particular type of investment are not matters on which I am qualified to express an opinion, and nothing I have said on financial aspects of the matter should be thought to be more than mere suggestions of factors which trustees and their advisers may wish to take into account. So expert advice would generally be required by charity trustees contemplating the advantages and disadvantages of turning their back on CIAs or SCAs. The extent to which excluding such investments from the permissible range involves a serious issue in terms of loss of scope for diversification and the dangers of such exclusion is pre-eminently a matter for financial decision-making of the kind which resulted in the crucial assessment of the Church Commissioners in Harries (namely that they were being asked to accept limitations which on financial grounds they believed to be unacceptable); the extent to which the market has failed to price in material scope for long term loss, for example in the form of the stranded assets thesis, or of concerns about climate change or other environmental or social costs, is of course a more difficult form of assessment, but it is still one for expert advice (though as I have said, given the material nature of the potential risks involved, this is or ought to be a matter of concern to all investors and it may well be thought that the concern can only grow if science moves as it has done in recent years).

31. I thus do not know whether in the case of any of the three types of assets to which I have referred – namely CIAs, SCAs or EDAs – there will prove to be if not a compelling financial case then at least some legitimate scope to abandon what are perceived to be ethically questionable forms of investment.

32. What I would state on my reading of the current law is that, in the absence of a conflict with the purposes of the trust, the onus remains on trustees to satisfy themselves that what they regard as an unsuitable species of investment can be excluded from their consideration, but that that onus may now be thought to be less burdensome than it was before the legislation and scientific advances of the last few years. I myself think that it would be difficult to argue from the published materials that CIAs in particular do not arguably involve material financial risks of concern to all investors, such that all fiduciaries should take advice, and give such assets careful thought before committing any substantial portion of their funds to investment in that area.

33. If that be right, then in applying the rules emerging from Scargill and Harries it seems to me quite possible in the case of charitable funds to find that the ethical and financial balancing act required to justify an approach which limits the trustees' freedom to invest in CIAs and other species of SCAs is such that the financial does not compete with the ethical but actually points in the same direction, so as to make the adoption of an ethical approach entirely appropriate. I have been supplied with charts showing the performance of indices excluding fossil fuels as compared with indices including fossil fuels; and whether the comparison be made on the basis of all-world markets or developed or emerging markets the conclusion seems to be the same - the exclusion of fossil fuels, if not actually advantageous (as may in some market conditions prove to be the case) appears to involves

no discernibly greater risk of financial loss than investment without exclusion of fossil fuels.

34. It is for the financial adviser to say whether this is correct, and if so whether it is a short term phenomenon or one with longer time horizons, but if the latter be the case then to exclude the possibility of investment in the realms of fossil fuels at least can hardly be said to carry such financial dangers that this would not be a proper case for applying the approach indicated by Nicholls V-C in Harries as summarized in paragraph 18, which requires trustees to judge whether material financial loss will result from a decision which on environmental grounds they would think desirable.

Summary

35. Against this background and in conclusion:

(i) I echo the principle that in general investment is a word which denotes the intent to secure a financial return for the beneficiaries and so the starting point when investing is to seek to find the best financial returns in the market, whilst having regard to the need to manage risk. Diversification brings with it a ready if not complete means to manage the risk of underperformance in one or more parts of a portfolio by reducing dependence on one or more asset classes and so caution should be exercised before reducing the scope for diversification; but diversification is not required to the fullest extent possible (see Harries) – the question, as that case makes clear, is whether a tool for managing risk is itself at risk of being excessively qualified.

(ii) Where the suggested investment would actually conflict with the benefit sought to be achieved by a given charity, (i.e. where a species of investment might

reasonably be expected to be inconsistent with the objects of the charity, as in the case of the cancer research charity faced with the possibility of a tobacco investment), then it must be ruled out of consideration regardless of the financial consequences; what may be called a patent conflict is enough in itself to justify the ethical approach and is sufficient to reverse the normal presumption that the onus falls on charity trustees to show that an ethical approach is appropriate in the circumstances. It is for charity trustees to determine whether there is a link between the specific purposes of a charity and the dangers posed by the investments concerned, such as in the case of CIAs, in the light of the prevailing evidence. Though the conflict may not always be clearcut, I think it at least arguable that investment in CIAs could be said to be irreconcilable with the intent behind charities with:

(a) general or specific environmental purposes;

(b) general health purposes;

(c) general poverty purposes;

(d) other purposes relating to matters where the properties of CIAs and the consequences of dangerous climate change are of particular concern.

In cases where the presence of a conflict could be said to be a matter of opinion it seems to me that if the financial advice is that there are material risks of financial detriment in making any such investments it must be proper for the charity trustees as a matter of discretion to reject them; but even if the advice be not so strong, then, so long as it can properly be said that there are no material risks of financial detriment in not including such investments in the portfolio, I see no reason why the charity trustees should not follow the ethical pointers to be derived from their trusts.

(iii) The same is true of a charity where either supporters or beneficiaries may be alienated, or the work of the charity may be impeded, by the relevant investment, and if there is no countervailing case for saying that financial reasons (whether in terms of diversification or otherwise) require the objections to the investment to be disregarded; a latent conflict of this kind is likely to be enough to justify, and may in some cases require, an ethical approach if the financial considerations do not compel a contrary view.

(iv) There are then three cases where though there is no clear conflict, whether patent or latent, nonetheless ethical policies may if the charity trustees so think fit be pursued; these cases are where:

> (a) it is arguable that a conflict arises though it is a matter of subjective opinion whether it does or not, but there is no financial detriment in giving effect to the relevant policy;
>
> (b) it is clear that charitable moneys should not be used to support what is on analysis an anti-social enterprise amounting to an "evil or tainted source", such as might be argued to be case with respect to pornography;
>
> (c) investments are in the reasonable opinion of the charity trustees not suited to the investment of public moneys because they are perceived to offer public disbenefits not outweighed by financial advantages.

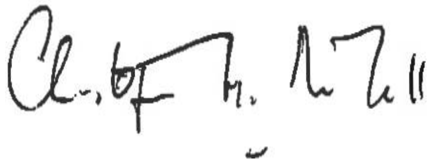
(v) Finally, there is the case where financial analysis shows the investment category to be disadvantageous because of a supposed element of mispricing in the market or a concern that market appetite may decline or a fear that regulatory burdens may be imposed in the future which will render any such investment positively

disadvantageous. Plainly investment in such assets should not be countenanced unless it is absolutely essential to do so to achieve a balanced portfolio. It is for trustees to determine, on the basis of financial advice, whether such concerns and fears are well placed, whether in the case of CIAs or elsewhere.

(vi) In any event, it may be thought that the potential financial risks attaching to CIAs, if well founded, are of such a nature and magnitude that they should at least be considered and assessed by any prudent charity trustee.

The Way Ahead

36. In some senses the question what is the way ahead is almost the hardest of all. It is clear that a reference to the charity tribunal would be the only profitable means of obtaining general guidance from the Courts on how charities at large should approach the issue of ethical investment, because that is a general question which needs an answer which will be wider than can be obtained in a debate relating to any one particular charity; and the concept of a reference was introduced precisely so that general questions could be resolved. If the idea of a reference is not thought to be appropriate by the Charity Commission or the Attorney General, it is in my view essential to ask the Charity Commission to issue guidance on the issue of ethical investment for the benefit of the charitable sector as a whole.



Christopher McCall Q.C. 16 November 2015

Maitland Chambers, Lincoln’s Inn,
London
WC2A 3SZ

THE POWERS AND DUTIES OF CHARITY TRUSTEES AS TO ETHICALLY QUESTIONABLE INVESTMENTS WITH SPECIFIC REFERENCE TO CARBON INTENSIVE ASSETS

OPINION
(November 2015)

Bates Wells & Braithwaite London LLP