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Fiduciary Duties of Investment Intermediaries



Law Commission

Fiduciary Duties of Investment Intermediaries

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FIDUCIARY DUTIES OF INVESTMENT INTERMEDIARIES

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THE LAW COMMISSION

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THE LAW COMMISSION
FIDUCIARY DUTIES OF INVESTMENT
INTERMEDIARIES

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GLOSSARY

Active investment

An approach to investment which involves the continuous buying and selling of investments. An active investment manager will typically seek to outperform an investment benchmark.

Active member

Members who are currently accruing benefits under the scheme.

Actuary

A professional who specialises in statistics and risk who gives advice on a pension scheme's assets and liabilities. They will predict movements in the scheme, such as deaths, retirements and withdrawals, and estimate the costs of providing the benefits due and accruing in the future.

Annuity

A fixed sum of money paid to individuals each year upon retirement. This may be for an agreed period or for the rest of the individual's life. The amount of money paid will depend on the individual's total accumulated pension savings.

Asset manager

See "investment manager".

Automatic enrolment

Also known as "auto-enrolment". A new legislative requirement introduced by the Pensions Act 2008 which requires all employers (beginning with the largest) to automatically enrol their qualifying employees into a qualifying pension scheme.

Best of sector

Also known as "best of class". Companies that perform best in their industry sector against specified indicators.

Broker

An individual or organisation that acts as an intermediary between a buyer and seller, usually in return for the payment of a commission.

Bundled scheme

A pension scheme where the pension provider also administers the scheme.

COBS

Conduct of Business Sourcebook. The section of the Financial Conduct Authority's Handbook that deals with business standards.

Contract-based scheme

These may be work-based or individual. In work-based contract-based schemes, the employer appoints a pension provider, usually an insurance company, to administer their pension scheme. The employees enter into a contract directly with the pension provider, although the employer may make arrangements to collect and pay contributions. In individual contract-based scheme, an individual enters into a contract directly with a pension provider.

Contributions

The money paid by members and employers into the pension scheme.

CP 215

Fiduciary Duties of Investment Intermediaries (2013) Law Commission Consultation Paper No 215.

Custodian

An institution that is responsible for the safekeeping and administration of assets belonging to another. Custodians will often handle administrative arrangements such as collecting coupons and dividends.

Default fund

The investment fund into which employees' contributions are paid if they fail to make an active choice of fund. It is usually designed for this purpose.

Deferred member

A member that no longer contributes to or accrues benefits under a scheme but has not yet begun to receive retirement benefits from that scheme.

Defined benefit (DB) schemes

Also known as "final salary" schemes. A type of pension where the amount an employee receives on retirement is pre-determined, and is often calculated on the basis of the employee's final salary and length of service. The amount received on retirement does not depend on the performance of the pension scheme's investments.

Defined contribution (DC) schemes

Also known as "money purchase" schemes. A type of pension where the amount received by a member on retirement will be calculated by reference to the contributions the employee makes to the scheme and the investment return on those contributions.

Department for Work and Pensions (DWP)

The government department responsible for pensions policy.

Direct payment arrangements

Arrangements between the member and the employer under which contributions fall to be paid by the employer towards the scheme. Such arrangements will exist where the employer arranges to make employer contributions to a personal pension scheme and/or where the employer arranges to deduct the member's contributions from pay and to pay them across to the pension scheme for the member.

Environmental, social and governance (ESG) factors

Sometimes referred to as "responsible investing". Refers to the use of certain non-financial factors in the investment decision-making process.

Financial Conduct Authority (FCA)

The regulator of the financial services industry. Took over some of the functions of the now abolished Financial Services Authority (FSA). The FCA is responsible both for regulating the infrastructure of financial markets and standards of conduct. It regulates defined contribution (contract-based) schemes and individual personal pensions.

Financial Services Authority (FSA)

A now defunct financial services regulator. Abolished in 2013 and replaced by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA).

Financial Ombudsman Service (FOS)

A body set up by the Financial Services and Markets Act 2000 to deal with complaints in relation to financial services and products.

Financial Reporting Council (FRC)

The regulator responsible for corporate governance standards and financial reporting. It publishes the UK Stewardship Code, which sets out a number of areas of good practice to which the FRC believes institutional investors should aspire.

FSMA

Financial Services and Markets Act 2000. The main piece of legislation governing UK financial markets regulation.

Fund manager

See "investment manager".

Income drawdown

The ability to take income from a pension whilst the pension remains invested. This is an alternative to purchasing an annuity.

INSPRU

Prudential Sourcebook for Insurers. The section of the Financial Conduct Authority's Handbook that deals with prudential requirements for insurers.

Investment consultant

An individual (or organisation) that gives strategic advice on the making of investments and/or the selection of an investment manager.

Investment intermediary

An intermediary in the investment chain. In a typical investment chain this includes investment managers, brokers and custodians.

Investment manager

Also known as a "fund manager" (for example, in the pensions legislation) and an "asset manager". An individual (or organisation) to whom the responsibility for the day-to-day management of the scheme's assets is delegated. The investment manager will act on the basis of instructions given to them in the investment mandate.

Investment mandate

The agreement between an investment manager and their client outlining how the assets of the pension scheme are to be managed. The mandate may contain performance targets by reference to a benchmark, or may contain restrictions on which investments the investment manager can make.

Lifestyling

An investment strategy where the allocation of a member's investments is adjusted depending on age and length of time to retirement. For example, as a member gets older, a member's investments are likely to be moved out of equities and into less risky investments such as cash and bonds.

Mark-to-market

A valuation of assets on the basis of their current market value, rather than the potential value they are expected to achieve.

Member

An individual who contributes or has contributed to a pension scheme.

MiFID

Markets in Financial Instruments Directive. This is European legislation intended to harmonise the provision of investment services to achieve similar regulatory outcomes across member states.

Modern portfolio theory

A theory that emphasises the risk level of the entire portfolio rather than the risk attaching to each investment taken in isolation. Assets that are particularly risk may be offset by other, safer, investments to form a balanced portfolio of investments.

National Employment Savings Trust (NEST)

A government-sponsored defined contribution occupational pension scheme. It is intended to be the default scheme made available to employees as employers become subject to auto-enrolment. NEST must accept any employer who wants to use the scheme for auto-enrolment. Employers can use NEST as their only pension scheme or alongside other pension schemes. NEST is regulated by HM Revenue and Customs and the Pensions Regulator.

Negative screening

The use of ethical, social and governance (ESG) factors to exclude investment in particular companies or sectors, such as tobacco companies or pesticide manufacturers.

Passive investment

An approach to investment which typically involves tracking the investment performance of a specific market index. A passively managed fund is also known as an “index fund”.

Pension Protection Fund (PPF)

A statutory fund created by the Pensions Act 2004. Its function is to provide compensation to members of eligible defined benefit pension schemes in the event that there is a qualifying insolvency event in relation to the employer, and where there are insufficient assets in the pension scheme to cover the Pension Protection Fund level of compensation.

PERG

Perimeter Guidance Manual. The section of the Financial Conduct Authority’s Handbook that explains the circumstances in which authorisation is required or exemption is available. It also explains the activities that are regulated under the Financial Services and Markets Act 2000 and the exclusions which are available.

Platform

Also known as an “investment platform”. May refer both to a “platform” as a piece of technology or to an intermediary who facilitates the purchase of investments.

Portfolio-churning

The excessive buying and selling of investments in a portfolio. It is characterised by very short holding periods for stocks.

Positive screening

The use of ethical, social and governance (ESG) factors to select firms (in which to invest) engaged in what are considered to be desirable practices, such as renewable energy supply.

Proxy agent

Advise on how votes should be cast and cast votes at company meetings on behalf of others.

Shareholder engagement

An approach to investment which emphasises the importance of effective dialogue between investors and investee companies. Engagement may involve an exchange of views on issues such as strategy, performance, board membership and quality of management.

Stakeholder pension

A type of defined contribution pension plan introduced in 2001 by the Welfare Reform and Pensions Act 1999. They are designed to be a low-cost and easy-to-understand.

Statutory funding objective

A funding requirement set by law which requires defined benefit pension schemes to maintain sufficient and appropriate assets to cover the amount required, on an actuarial calculation, to make provision for the scheme's liabilities.

Stewardship

A philosophy which aims to promote the long term success of companies in such a way that protects and enhances the value that accrues to the ultimate beneficiary of an investment. It is usually discussed in the context of institutional investors. Stewardship activities include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration.

Stock lending

The temporary transfer of shares, by a lender to a borrower, with agreement by the borrower to return equivalent shares to the lender at pre-agreed time. The lender will give the borrower collateral as security and will pay lending fees. The purpose of stock lending is to usually to allow the borrower to sell short, that is sell shares that the borrower does not own. The borrower will then purchase equivalent shares in the market to return to the lender. If the market price of the shares has fallen below the price at which the borrower sold the shares, the borrower will make a profit.

The Pensions Ombudsman (TPO)

An independent officer who investigates and decides complaints and disputes about the way pension schemes are run.

The Pensions Regulator (TPR)

The statutory regulator of work-based pensions (including both trust-based and contract-based schemes). Its objectives are to protect the benefits of members of occupational pension schemes (and personal pension schemes where there is a direct payment arrangement), to promote and improve understanding of the good administration of work-based pension schemes and to maximise employer compliance with their duties under the Pensions Act 2008. TPR is also responsible for reducing the risk of situations arising that may lead to compensation being payable under the Pension Protection Fund.

Transaction costs

The variable costs associated with buying, holding and selling the underlying investment instrument. Examples of transactions costs include brokers' commissions, bid-offer spreads and transaction taxes.

Trust-based scheme

A pension scheme that is established using a trust. The trustees are responsible for managing the scheme and for reviewing and monitoring investments.

THE LAW COMMISSION

FIDUCIARY DUTIES OF INVESTMENT INTERMEDIARIES

To the Right Honourable Chris Grayling, MP, Lord Chancellor and Secretary of State for Justice

CHAPTER 1 INTRODUCTION

- 1.1 The Law Commission has been asked to investigate how the law of fiduciary duties applies to investment intermediaries and to evaluate whether the law works in the interests of the ultimate beneficiaries.
- 1.2 This project was commissioned by the Department for Business, Innovation and Skills (BIS) and the Department for Work and Pensions (DWP) in March 2013. Following initial consultation, we published a consultation paper in October 2013 and received responses from 96 consultees.¹ This is our final report.

THE KAY REVIEW

- 1.3 The project arose from the Kay Review, published in July 2012.² Professor Kay conducted a year-long review of the UK equity market and was highly critical of the way it worked.
- 1.4 Professor Kay considered that investment chains were too long, with growing numbers of intermediaries between an investor and the company in which they invest. He argued that this led to increased costs, misaligned incentives and reduced trust.

Short and long-term decisions

- 1.5 According to Professor Kay, the central problem was “short-termism”, in which many investment managers “traded” on the basis of short-term movements in share price rather than “investing” on the basis of the fundamental value of the company. Furthermore, shareholders did little to control bad company decisions:

We observe a wide variety of examples of companies that have made bad long-term decisions, and consider that equity markets have evolved in ways that contribute to these errors of managerial judgment.³

¹ Fiduciary Duties of Investment Intermediaries (2013) Law Commission Consultation Paper No 215 (CP 215).

² J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012) Recommendation 9.

³ Above, Executive Summary para vii.

- 1.6 The distinction between short and long-term thinking was crucial for both company directors and savers. Professor Kay emphasised that:

the goals of equity markets are to operate and sustain high performing companies and to earn good returns for savers without undue risk. The two perspectives are essentially identical. In the long run, the profits earned by high performing companies are the only source of returns for savers who invest in equities.⁴

- 1.7 Company directors interested in the long-term invest in the physical assets of the business, and “in the intangibles which are generally the source of their competitive advantage” – including their reputation, employees and capacity for innovation.⁵ By contrast, short-term decisions jeopardise long-term sustainability for immediate profit. Professor Kay listed firms which sacrificed safety, the environment and their reputations for immediate profits. He also gave examples of managerial “hyperactivity”, such as frequent internal reorganisation and extensive mergers and acquisitions, which distracted senior management from improving the capabilities of the underlying business. He commented that “many of the bad decisions described were supported or even encouraged by a majority of the company’s shareholders”.⁶
- 1.8 An aim of this report is to evaluate how far the law encourages pension funds and others to make “long-term investment decisions”. It is therefore important to explain what is meant by this term. According to Professor Kay, long-term investors would choose companies which make good long-term decisions. They would anticipate holding shares for many years, would monitor company decisions and would engage with directors to keep them on track. Their focus would be on the underlying strength of the company. This contrasts with “trading” on the basis of short-term movements in share prices, where the focus is on “anticipating what average opinion expects the average opinion to be”.⁷

Observing fiduciary standards

- 1.9 Professor Kay set out ten principles which should guide the UK equity market. Principle 5 was that “all participants in the equity investment chain should observe fiduciary standards in their relationships with their clients and customers”. He continued:

Fiduciary standards require that the client’s interests are put first, that conflict of interest should be avoided, and that the direct and indirect costs of services provided should be reasonable and disclosed. These standards should not require, nor even permit, the agent to depart from generally prevailing standards of decent behaviour. Contractual terms should not claim to override these standards.

⁴ J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012) para 1.5 (footnote omitted).

⁵ Above, para 1.1.

⁶ Above, para 1.28.

⁷ Above, para 5.18, quoting JM Keynes, *The General Theory of Employment, Interest and Money* (1936).

- 1.10 Professor Kay noted that fiduciary duties are a legal concept created by case law. Fiduciary duties clearly apply to pension and other trustees, but there was uncertainty and debate about how far they applied to others in the investment chain. Even among pension trustees there was uncertainty over what fiduciary duties required:

A number of submissions – in particular, powerful argument from FairPensions – suggested that some pension fund trustees equated their fiduciary responsibilities with a narrow interpretation of the interests of their beneficiaries which focused on maximising financial returns over a short timescale and prevented the consideration of longer term factors which might impact on company performance, including questions of sustainability or environmental and social impact ... Lawyers who participated in our discussions, however, suggested that the law allowed a more robust interpretation. Several commented that pension fund trustees who insisted on a narrow view of fiduciary duty were often hiding behind risk-averse legal advice, designed to protect the adviser and client rather than to provide guidance as to the proper discharge of fiduciary duty.⁸

- 1.11 Therefore, Recommendation 9 said:

The Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers.

The Government's response

- 1.12 In November 2012 the Government published a response to the Kay Review which accepted the analysis and conclusions of the report. As far as fiduciary duties were concerned, the Government commented that the phrase could be used in several different ways:

Since the Kay Report was published there has been a great deal of discussion of the meaning and scope of the word “fiduciary”. Many interpret it in the strict legal sense of a relationship in which the principal is reliant or dependent on the knowledge, expertise and discretion of an agent, and to which the strictest duties of loyalty and prudence are applicable. Others however use the word fiduciary to describe a more general duty of care.⁹

- 1.13 The Government therefore elected to avoid using the word “fiduciary” and instead set out the following principle for equity markets:

All participants in the equity investment chain should act:

- (a) in good faith;

⁸ J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012) para 9.20.

⁹ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The Government Response to the Kay Review* (November 2012) para 2.8.

- (b) in the best long-term interests of their clients or beneficiaries;
- (c) in line with generally prevailing standards of decent behaviour.

This means ensuring that the direct and indirect costs of services provided are reasonable and disclosed, and that conflicts of interest are avoided wherever possible, or else disclosed or otherwise managed to the satisfaction of the client or beneficiary.

These obligations should be independent of the classification of the client.

They should not be contractually overridden.¹⁰

TERMS OF REFERENCE

1.14 Our terms of reference from BIS and DWP are set out in full in Appendix A. They go beyond Recommendation 9 in the Kay Review. Briefly, we have been asked to do five things:

- (1) Investigate how fiduciary duties currently apply to investment intermediaries and those who provide advice and services to them.
- (2) Clarify how far those who invest on behalf of others may take account of factors such as social and environmental impact and ethical standards.
- (3) Consult relevant stakeholders.
- (4) Evaluate whether fiduciary duties (as established in law or as applied in practice) are conducive to investment strategies in the best interests of the ultimate beneficiaries. We are asked to carry out this evaluation against a list of factors. In particular, do they reflect an appropriate understanding of beneficiaries' best interests, are they sufficiently certain, and do they encourage long-term investment strategies?
- (5) Identify areas where changes are needed.

¹⁰ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The Government Response to the Kay Review* (November 2012) para 2.8.

- 1.15 Although the research for this project has focused principally on the law of England & Wales, the equities market is a UK one, not neatly split between England & Wales and Scotland. In many (though not all) respects, the law of fiduciary duties is the same in Scotland. We have worked closely with the Scottish Law Commission to identify similarities and differences between the law in the two jurisdictions, which we note from time to time.¹¹ We are very grateful for the help given to us by the Scottish Law Commission, but this is not a joint publication of the two Commissions.

THE MEANINGS OF FIDUCIARY DUTY

- 1.16 As the Government acknowledged in its response to the Kay Review, the term “fiduciary duty” is used in different ways by different people.¹²
- 1.17 In the Consultation Paper, we explained that the term is often used by pension trustees to emphasise their ethos, which is to act in the interests of the beneficiaries.¹³ Many trustees were aware of their status as fiduciaries, which resonates with a sense of altruism.¹⁴ The association between “fiduciary duty” and altruism has given the term some rhetorical power. The rhetoric has been used to visualise an alternative approach to financial markets, which is less driven by financial gain and more attuned to the needs of investors.
- 1.18 To lawyers, the term denotes an area of judge-made law, often associated with trusts and equities. Lawyers tend to think in terms of litigation, so the statement “intermediaries should owe fiduciary duties to the end investor” implies that investors should be able to sue intermediaries for breach of these duties, with the various costs and risks that entails.

¹¹ Financial services (including investment business and insurance), financial markets and occupational and personal pension schemes are matters reserved to the UK Parliament: Scotland Act 1998, sch 5, Part 2, Heads A3, A4 and F3. Whilst the Scots law of trusts is devolved to the Scottish Parliament, this is subject to the reservation in respect of pensions. In particular, the obligations of the trustees or managers of occupational and personal pension schemes are a reserved matter. The Scottish Law Commission is completing a report on Trusts Law which it expects to publish later in 2014: see <http://www.scotlawcom.gov.uk/law-reform-projects/trusts/>.

¹² Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The Government Response to the Kay Review* (November 2012) para 2.8.

¹³ CP 215 para 1.21.

¹⁴ See, for example, the statements made to Anna Tilba and Terry McNulty: A Tilba and T McNulty, “Engaged versus Disengaged Ownership: The Case of Pension Funds in the UK” (2013) 21(2) *Corporate Governance: An International Review* 165 at 172.

- 1.19 Even for lawyers, the term “fiduciary duties” is used in different ways. In the past, it has been used in a broad sense to encompass all the various duties owed by fiduciaries to their principals, including duties of care and duties which arise from the exercise of a power. As we discuss in Chapter 2, the courts have issued stern warnings against using the term in this broad, loose sense. Instead the courts have emphasised that the core of fiduciary duty is “the obligation of loyalty”, so that breach “connotes disloyalty or infidelity”.¹⁵ Mere incompetence is not enough. Fiduciaries often also owe duties not to be negligent, but these are distinct from fiduciary duties.
- 1.20 In many ways fiduciary duties can be thought of as “legal polyfills”, moulding themselves around other structures to plug the gaps. They are not the whole structure. Therefore, to answer practical questions about legal duties in financial markets, it is often necessary to draw on three or four different types of law. In particular, to answer questions about the investment duties of pension trustees, it is necessary to consider pensions legislation, duties that attach to the exercise of a power and duties of care as well as “fiduciary duties” in the strict sense.

WHO INVESTS IN UK EQUITIES?

- 1.21 If we are to evaluate how well the law meets the needs of the end investor, our first task is to establish who those end investors are. In the Consultation Paper we described the difficulties of answering this question. The data provided is confined to broad categories, such as “insurance company”, “unit trust”, “rest of the world”, which generally refers to other intermediaries rather than the ultimate beneficiary.
- 1.22 However, a broad picture emerges. Since the mid-1990s, UK pension funds have been moving out of UK equities and into overseas markets and safer asset classes, such as bonds. Meanwhile, many UK equities are owned by foreign owners, such as overseas pension funds and sovereign wealth funds. Pension funds told us that less than 10% of their assets are now in UK equities.
- 1.23 The result is that there is now only a weak link between the investment decisions of pension funds and the UK equities market. However, this is not because pensions funds have been replaced by another, more powerful type of investor. Rather, it reflects the global and diversified system of finance. A central challenge identified by Professor Kay is that investors are now so varied and fragmented that they find it difficult to influence corporate decisions, even when it is in their collective interests to do so.

¹⁵ *Bristol & West Building Society v Mothew* [1998] Ch 1 at 18.

A PENSIONS FOCUS

- 1.24 In this report we focus on pensions, for three reasons. First, the central issue which we have been asked to consider is the one raised by FairPensions¹⁶ and others in the course of the Kay Review: how far does the law require pension fund trustees to focus on maximising financial returns over a short timescale, rather than consider other longer term factors, such as environmental and social impact? To provide practical commentary on this answer, it is necessary to look at the context, law and problems of pension provision more generally. For this reason, we start with a description of the pensions landscape, outlining the complexity of pension law and regulation and the many challenges it faces.
- 1.25 Secondly, pensions are a crucial investment for many UK citizens, and an area where people are especially vulnerable to the failures of financial markets. In Chapter 9 we report serious concerns about the extent to which financial intermediaries in the pensions market are acting in the best long-term interests of beneficiaries. This provides a particularly acute example of the difficulties of regulating financial markets, illustrating both the role and limitations of the law of fiduciary duties in ensuring that those in the equity investment chain act in accordance with the principles set out in the Government's response to the Kay Review.
- 1.26 Thirdly, in the Consultation Paper we used pensions as a lens through which to understand the investment market, tracing a chain of intermediaries from the prospective pensioner/saver to the registered shareholder of a UK company. The chain typically includes, among others, investment consultants, investment managers, collective investment schemes, brokers and custodians. In Chapters 10 and 11 we use this work to explain how fiduciary duties apply through the investment chain. Much of this explanation is equally relevant to UK consumers investing through collective investment vehicles.
- 1.27 We are aware that we have not considered the needs of other major investors, such as sovereign wealth funds and foreign pension funds. One reason is that many of the links in the chain from foreign investors to UK equities are not governed by UK law. Furthermore, as the Law Commission of England and Wales we did not feel that we had the authority or experience necessary to assess the needs of overseas investors.

OTHER TRUSTS

- 1.28 There are other types of trusts which invest on behalf of others. Family trusts and charities are common examples. Many of the general principles we have outlined in relation to pension trustees will apply to other forms of trusts. However, the practical consequences may differ. Family trusts will be smaller and have a more clearly defined group of beneficiaries. Charitable trusts may invest simply for a financial return (whether income or capital growth) or, in some cases, they may engage in social investment. Social investment is intended both to produce financial return and to further the charity's purposes, as where a homelessness charity invests in low-cost housing.

¹⁶ FairPensions are now ShareAction.

OUR REVIEW OF SOCIAL INVESTMENT BY CHARITIES

- 1.29 The Law Commission is conducting a separate review of social investment by charities, including charitable trusts, as part of its project on Selected Issues in Charity Law. The review was prompted by concerns that the legal basis for such investment is unclear.¹⁷
- 1.30 On April 2014, the Law Commission published a consultation paper which considers the powers and duties of charity trustees in making social investments.¹⁸ We explained that charities exist for the benefit of the public and must have exclusively charitable purposes.¹⁹ We said:
- To achieve their purposes, charities have traditionally either spent their funds in support of their initiatives, or invested them so as to generate further funds for future initiatives. A charity making a social investment combines these objectives; it enters into a transaction from which it seeks to achieve both its charitable purposes ... and a financial benefit.²⁰
- 1.31 We noted that some charitable trustees take the view that they are duty-bound to obtain the best risk-adjusted financial return when exercising their power of investment, which prevents them from making social investments that yield a below-market rate of financial return or carry a high degree of risk. We do not share that view.²¹ Instead, our provisional view is that, when making a social investment, charity trustees should obtain the best overall return from the investment, based on the combination of the financial benefit from the transaction and the extent to which the transaction achieves the charity's purposes.
- 1.32 We provisionally proposed the introduction of a statutory power for charities to make social investments, to be accompanied by a checklist of factors that trustees may consider when exercising the new power.
- 1.33 The consultation period closed on 18 June 2014 and we are currently considering the responses

THE CONSULTATION RESPONSES

- 1.34 In all, 96 consultees responded to the Fiduciary Duties of Investment Intermediaries Consultation Paper. Many of the responses went into great detail and were closely argued. We recognise that this must have involved a huge amount of work. We are extremely grateful to all those who responded.

¹⁷ Lord Hodgson of Astley Abbotts, *Trusted and Independent: Giving charity back to charities – review of the Charities Act 2006* (July 2012).

¹⁸ Social Investment by Charities (2014) Law Commission Consultation Paper No 216.

¹⁹ Above, para 1.6.

²⁰ Above, paras 1.12 to 1.13.

²¹ Social Investment by Charities (2014) Law Commission Consultation Paper No 216 paras 3.65 to 3.67.

- 1.35 We received responses from a wide range of consultees, which we have allocated to the following categories:

<i>Type of consultee</i>	<i>Number of responses</i>
Academics	11
Actuaries (and associations)	3
Custodians	2
Individuals	11
Insurance companies (and associations)	3
Interest groups	19
Investment consultants	2
Investment managers (and associations)	13
Other	13
Regulators/Government departments	3
Solicitors, barristers, judges (and lawyers' associations)	13
Trustees (and associations)	3
Total	96

THIS REPORT

- 1.36 This report differs from most other Law Commission reports in that it does not focus on recommendations for legislative reform. Our primary aim is to explain the nature of fiduciary and other duties to act in the best interests of savers, and to describe how these duties apply to investment intermediaries. We hope this report will bring greater clarity to this difficult area.
- 1.37 We have been asked to evaluate whether fiduciary duties (as established in law or as applied in practice) are conducive to investment strategies in the best interests of the ultimate beneficiaries. This evaluation has required us to highlight the limits of what judge-made duties can do in making investment markets work. Fiduciary duties are not a silver bullet which will slay the evils of short-termism or narrow self-interests.
- 1.38 When fiduciary duties work well, they operate alongside regulatory rules and market structures which align the interests of the intermediary with those of the saver. However, there are gaps in both judge-made duties and regulatory rules, which mean that the end-investor is not always protected. We have highlighted some of these gaps. It is not part of our terms of reference to solve all the problems we have identified. Instead, we recommend action by others, including The Pension Regulator, the Financial Conduct Authority and the Government.

Structure

- 1.39 The report is divided into four broad parts. The first is background. We start with a brief introduction to pensions. We then explain the nature of fiduciary duties and how they sit within a matrix of other statutory and judge-made duties (including duties which attach to a power and duties of care).
- (1) Chapter 2 provides a summary of pension provision in the UK and the many changes to it.
 - (2) Chapter 3 introduces the concept of “fiduciary duties” and explains how fiduciary duties interact with other legal duties.
- 1.40 The next four chapters focus on the factors influencing pension trustees when devising an investment strategy. We have been asked whether trustees may (or must) consider a range of factors, including questions of environmental and social impact; generally prevailing ethical standards; and the ethical views of beneficiaries.
- (1) Chapter 4 outlines the legal framework that governs how pension trustees make investment decisions. It summarises the main cases on this issue.
 - (2) Chapter 5 revisits the tentative conclusions we reached in the Consultation Paper and discusses the responses we received. These responses have led us to revise the expression and detail of our conclusions, if not the main substance.
 - (3) Chapter 6 sets out the Law Commission’s conclusions on factors which pension trustees may or must take into account when making investment decisions. Although it is based on the legal material in Chapter 4 and the discussion in Chapter 5, it is intended as a stand-alone chapter. We hope that it will act as a useful clarification of the law in this area, which will be of assistance to trustees and others involved in these decisions.
 - (4) Chapter 7 explores whether the current law represents an appropriate understanding of beneficiaries’ best interests, and whether there is a need for further reform. We conclude that the law is right in substance, but also complex and inaccessible. We examine ways to make the law more accessible.
- 1.41 The next two chapters ask how far those responsible for Defined Contribution (DC) workplace pensions are required to act in the long-term best interests of their beneficiaries, and how these duties operate in practice.
- (1) Chapter 8 outlines the duties of contract-based pension providers to act in the best interests of members.
 - (2) Chapter 9 explores the practical effect of the duties of both contract-based and trust-based pension schemes to act in the best interests of members. The chapter summarises recent studies into the problems encountered in DC workplace pensions. It outlines the Government’s response and looks at some of the continuing challenges of improving governance in the schemes.

- 1.42 The final two chapters examine the way that fiduciary duties apply in the rest of the investment chain.
- (1) Chapter 10 discusses the extent to which intermediaries along the chain owe fiduciary duties.
 - (2) Chapter 11 discusses particular concerns about investment consultants, stock lending and intermediated shareholding.
- 1.43 At Appendix A we set out our terms of reference. Appendix B sets out extracts from the Pensions Act 1995 and the Occupational Pension Schemes (Investment) Regulations 2005.²² Appendix C contains a list of those who responded to our Consultation Paper.

THANKS AND ACKNOWLEDGEMENTS

- 1.44 We are very grateful for the help of our Advisory Committee: Vanessa Knapp OBE, Professor Hector MacQueen, Deborah Sabalot, Dr Anna Tilba and Professor Alastair Hudson. We also give particular thanks to Chris Stears, who served as an academic intern, to Clayton Utz and Freshfields Bruckhaus Deringer LLP for all their help on the Australian research paper,²³ and to Deborah Shedden for her interviews with market participants.
- 1.45 We thank those organisations that have so generously hosted events which enabled us to present our proposals for discussion and feedback. These are: Baker & McKenzie LLP, Sacker & Partners LLP, Eversheds LLP, Hogan Lovells International LLP, the National Association of Pension Funds, and the Edinburgh Centre for Commercial Law.
- 1.46 We also extend our thanks to the many consultees who responded to our Consultation Paper and those who assisted us by sharing their views and expertise. A full list of those who responded to the Consultation Paper is included in Appendix C.

²² SI 2005 No 3378.

²³ The paper is reproduced in CP 215, Appendix C.

CHAPTER 2

THE PENSIONS LANDSCAPE

- 2.1 Pensions have dominated our discussions. For most people, their pension is their most significant long-term investment in financial markets. It is the area of people's lives in which they most rely on investment intermediaries to look after their interests, and where they are most vulnerable if the system fails them. Historically, the pensions industry has also been a significant investor in the equity markets, meaning that pension schemes' decisions have implications for equity markets as a whole.
- 2.2 This project has come at a time of rapid change within pension provision, as old defined benefit pension schemes close and many new people are brought within defined contribution schemes by auto-enrolment. This chapter is intended as a brief introduction to the structure of pensions, and the challenges the industry faces.
- 2.3 Here we start by describing different types of pension and the way that they are regulated. We then consider recent changes to pension provision and conclude with an account of the continuing challenges.

TYPES OF PENSION SCHEME

- 2.4 For this project we are only concerned with funded pension schemes. We do not consider unfunded schemes, such as the Civil Service Pension Scheme, or state benefits.
- 2.5 Funded pensions may be arranged either through an employer or by an individual privately. Those arranged by an employer are of two main types:
- (1) "*Defined benefit*" (DB). In the private sector DB schemes are set up under trust,¹ though some public sector schemes are governed by statutory instruments instead.
 - (2) "*Defined contribution*" (DC). These may be set up under trust or may be made on an individual contractual basis with a private provider, typically an insurer.

¹ Until 6 April 2006, tax relief for occupational pension schemes was only available to schemes approved by HMRC and established under irrevocable trusts in accordance with the Income and Corporation Taxes Act 1988, s 592. There is now no such requirement.

DB schemes

- 2.6 DB schemes typically provide employees with a defined proportion of their final or career average salary on retirement.² Crucially, the amount an employee is promised does not depend on the performance of investments. Instead, the employer makes a contractual promise to pay a certain amount. Typically, both the employer and employee will make contributions to the scheme which are then invested to generate a return. If the scheme is in deficit,³ the employer will usually be under an obligation to increase its contributions to the scheme to ensure it is brought back to balance.
- 2.7 By comparison with other pension schemes, DB contributions are generous. The Pensions Policy Institute calculates that the total level of contributions required to fund a typical final salary scheme is 21% of salary.⁴ By contrast, in 2010 average contributions to DC schemes open to new members were under 9%.⁵ DB membership peaked in 1967;⁶ many schemes have, therefore, been established for several decades and have built up substantial assets. In 2012 they controlled £1,031 billion of assets, compared with £697 billion of assets in DC schemes.⁷
- 2.8 Private sector DB schemes are set up under trust. As we explain in subsequent chapters, pension fund trustees (like other trustees) owe fiduciary duties to their members. Various duties attach to the exercise of their powers, and the courts have held that they must act in members' best interests.

² A common formula is $n/80$ of the employee's final salary on retirement, where n represents the number of years of the employee's pensionable service. According to this formula an employee who accrued 40 years of pensionable service would be entitled to a pension equal to $40/80$ or one half of his final salary on retirement. Many schemes are moving away from formulae based on final salary and are instead using an employees' average salary over the course of their career.

³ For these purposes, a scheme will be in deficit when the actuarial valuation of the trust's defined liabilities to its members exceeds the value of the trust assets which are available to fund them: D Fox, *Defined Benefit Pension Trusts: Asset Partitioning and the Residual Interest* (November 2010) p 7.

⁴ Pensions Policy Institute, *The changing landscape of pension schemes in the private sector in the UK* (June 2012) p 3.

⁵ Above, p 20. This figure has been arrived at by adding together average employer contributions (6.2%) and average employee contributions (2.7%).

⁶ Above, p 13.

⁷ Source: National Association of Pension Funds.

Statutory DB schemes

- 2.9 DB schemes in the public sector are typically established under statute rather than trust. Most public sector pensions are not funded: in other words, they do not hold or invest assets.⁸ However, the largest public service pension scheme, the Local Government Pension Scheme (LGPS) is a funded scheme. The LGPS has a membership of 4.7 million and a fund size of £180 billion,⁹ and is made up of locally managed funds.¹⁰ Each fund is managed by a designated administering authority, who are not trustees but act on the basis of their statutory powers and duties.
- 2.10 Public service schemes are generally unaffected by occupational pension scheme legislation. The main piece of legislation in this area is now the Public Service Pensions Act 2013, which sets out a common framework for new public service schemes. The schemes themselves will be governed by regulations made under the Act, and may also be subject to European directives.

DC schemes

- 2.11 Unlike DB schemes, in DC schemes members have no entitlement to a fixed level of income. Instead, each member's income on retirement depends on the performance of investments bought with the contributions they (and often their employer) have made to the scheme. Because the benefits ultimately paid out depend on what members' contributions are able to buy, DC schemes are often called "money purchase" schemes. The member will bear the risk of their investments not performing well.
- 2.12 Members may make a choice about how they would like their pension to be invested. However, most people find decisions about pensions to be complex, hard, unpleasant and time-consuming.¹¹ In practice, most members do not make a choice and are placed in the "default fund".¹² In Chapter 8 we discuss the challenges of ensuring suitability in both chosen and default funds.¹³

⁸ Generally, employee and employer contributions are collected and paid to the sponsoring government department, who then pay pension benefits, netting off contributions received: Pensions Policy Institute, *An assessment of the Government's reforms to public sector pensions* (October 2008) p 7.

⁹ The Pensions Regulator, *Public service pension schemes: A summary of governance and administration* (September 2013) p 14.

¹⁰ Above, p 15. There are 89 such funds in England and Wales.

¹¹ The Office of Fair Trading has summarised the evidence on this issue: Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014) paras 5.7-5.10. See also CP 215 paras 13.38 to 13.41.

¹² Under section 17(2)(b) of the Pensions Act 2008, schemes used by employers for the purposes of auto-enrolment must not require employees who are enrolled to express a choice, or provide information, in order to remain active members of the scheme. In particular, employees may not be required to make a choice about the fund into which their contributions may be invested. Therefore, all auto-enrolment schemes must have a default fund.

¹³ See paras 8.28 to 8.36 below.

Trust-based DC schemes

- 2.13 DC schemes may be trust-based or contract-based. Where DC schemes are set up under trust, the trustees will owe fiduciary and other duties to their beneficiaries. As with DB schemes, the trustees of DC schemes are required to act in the best interests of their members. However, the regulator does not subject them to the same funding oversight. For example, unlike DB schemes, they do not need a statutory funding objective.¹⁴

Contract-based schemes

- 2.14 Increasingly, pensions are being set up by means of a contract between an individual and a contract-based pension provider, typically an insurer. Duties under trust law do not apply to contract-based pensions. Instead, providers are subject to extensive regulation by the Financial Conduct Authority.
- 2.15 Below, we outline two types of contract-based schemes.

INDIVIDUAL PERSONAL PENSIONS

- 2.16 An individual may enter into a pension directly with pension providers, without any employer involvement. This is common, for example, amongst the self-employed. Such arrangements are known as individual personal pensions and take the form of a contractual relationship between an individual and the pension provider.

GROUP PERSONAL PENSIONS

- 2.17 Increasingly, employers make arrangements for their employees to take out “group personal pensions” with a pension provider. However, the employer has no ongoing responsibility for monitoring the performance of the scheme once it is in place.¹⁵ The responsibility of the employer is often limited, where direct payment arrangements are in place,¹⁶ to making direct contributions to the pension provider on behalf of the member.¹⁷
- 2.18 A group personal pension is characterised as a series of contracts between the individual members and the pension provider, who is typically an insurance company. We discuss the implications of this in Chapter 8.

¹⁴ Pensions Act 2004, s 221(1)(a). For an explanation of “statutory funding objective”, see para 2.49 below.

¹⁵ Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, February 2014) para 3.14.

¹⁶ These are arrangements between the member and the employer under which contributions fall to be paid by the employer towards the scheme. Such arrangements will exist where the employer arranges to make employer contributions to a personal pension scheme and/or where the employer arranges to deduct the member’s contributions from pay and to pay them across to the pension scheme for the member.

¹⁷ Improving governance and best practice in workplace pensions, Sixth Report of the Select Committee on Work and Pensions (2012-13) HC 768-II at Ev 135.

“Stakeholder” pensions

- 2.19 An added complexity in understanding DC pensions is the occasional reference to “stakeholder pensions”. Stakeholder pensions were introduced in 2001 as an encouragement for low earners to save for retirement.¹⁸ DC pensions did not have to be offered as stakeholder pensions, but if they were, members were provided with particular protections. The most important was that administration charges were capped at 1.5% of fund value in the first 10 years, and 1% thereafter.¹⁹ Stakeholder pensions could be set up under either trust or contract, and were available to both the employed and the self-employed.
- 2.20 In practice, “stakeholder” protection has now been superseded by the protections imposed on “qualifying schemes” for auto-enrolment, discussed below.

Options on retirement

- 2.21 A defined contribution pension is said to “accumulate” during the member’s working life, as contributions are made and invested, and to “decumulate” as the member draws on their savings to provide an income in retirement.
- 2.22 Until recently, individuals were effectively required to use the “pension pot” that they had built up during the accumulation phase to purchase an annuity by the time they turned 75.²⁰ By taking the pension pot and reinvesting it in corporate bonds and gilts, annuity providers promise to pay an individual a guaranteed income for life. The view of the Government of the day was that annuities were the most efficient way of turning capital into an income stream, and by guaranteeing individuals a constant income regardless of how long they lived reduced their possible future need for income-related support.²¹
- 2.23 In 2011, the Government removed the requirement to annuitise at 75.²² However, alternative options were limited. Whilst everyone was able to take 25% of their pension pot as a tax-free lump sum, only individuals with pension savings under £18,000 or a guaranteed income in retirement of over £20,000 had full flexibility over the rest of their pension pot.²³ Otherwise, individuals were limited to “capped drawdown”, where they could withdraw a pension of up to 120% of the value of an equivalent annuity per year, or full withdrawal subject to a 55% tax charge.

¹⁸ See A new contract for welfare: Partnership in pensions (1998) Cm 4179.

¹⁹ Stakeholder Pension Schemes Regulations 2000 SI 2000 No 1403, reg 14.

²⁰ The principle of mandatory annuitisation was first introduced by section 32 of the Finance Act 1921. The requirement to annuitise by 75 was introduced by section 30 of the Finance Act 1976.

²¹ Department for Work and Pensions, *Modernising Annuities: A Consultative Document* (February 2002) p 5.

²² Finance Act 2011, s 65; sch 16.

²³ Individuals with total pension savings of £18,000 or less could take their entire pension as a lump-sum. 25% of this would be tax-free and the rest taxed at the appropriate marginal tax rate. Individuals with a guaranteed income in retirement of over £20,000 (a pension pot of £310,000 at current annuity rates) could enter “flexible drawdown”. These individuals could withdraw freely from their pension, subject to their marginal rate of income tax.

- 2.24 The 2014 Budget gives individuals a greater amount of choice as to how they access their savings. Under the new system, individuals have the option of purchasing an annuity, or the option of full withdrawal and income drawdown at the marginal tax rate. All individuals retain the option of taking 25% of their pension pot as a tax-free lump sum.
- 2.25 Because there will no longer be a limit on who can take advantage of drawdown products, individuals will be able to choose for themselves whether they prefer the security of an annuity or the flexibility of income drawdown. These changes are intended to come into effect from April 2015.²⁴

AUTOMATIC ENROLMENT

- 2.26 Auto-enrolment is being phased in from October 2012 to October 2018. The scheme has started with large employers and will gradually be extended to medium and small employers.
- 2.27 Employers will be required to enrol all employees between the ages of 22 and state pension age into a pension scheme if they earn over the threshold (currently £9,440 a year). Employees have the right to opt out, but they must make a positive decision to do so. When the scheme is fully introduced, contributions must be at least 8% of band earnings (that is, earnings between £5,668 and £41,450 in 2013/14). Of this, at least 3% must come from the employer.
- 2.28 The duty to auto-enrol applies in respect of employees who are not already active members of a “qualifying scheme”.²⁵ These are schemes which meet the “qualifying criteria”. UK pension schemes which satisfy these criteria are tax-registered occupational and personal pension schemes that meet certain minimum quality standards, such as a minimum level of employee contributions.²⁶ Where employees are not already a member of a qualifying scheme, they must be enrolled into an “automatic enrolment scheme”. These schemes must, in addition to satisfying the “qualifying criteria”, satisfy the “automatic enrolment criteria”. They must not contain any provisions which prevent employers from auto-enrolling eligible employees, or which require employees to express a choice or provide information in order to remain an active member of the scheme.²⁷

²⁴ Transitional provisions have taken effect from 27 March 2014. These include reducing the minimum income requirement for entering flexible drawdown from £20,000 to £12,000, increasing the amount of total pension wealth which can be taken as a lump sum from £18,000 to £30,000, and increasing the capped drawdown withdrawal limit from 120% to 150%. See <http://www.hmrc.gov.uk/pensionschemes/benefits-reg-pens-schemes.htm>.

²⁵ Pensions Act 2008, ss 3(2)-(3).

²⁶ Above, s 16.

²⁷ Above, s 17.

- 2.29 Much of the growth in DC schemes is likely to be in contract-based pensions, but not exclusively. There is also likely to be a growth in “master trusts”, that is trust-based schemes covering multiple employers.²⁸ The most important “master trust” is the National Employment Savings Trust (NEST), set up by the previous Government to ensure that all employers have access to a low-cost scheme.²⁹ NEST is run as a trust on a not-for-profit basis and has low contribution and annual management charges.³⁰
- 2.30 Other new providers have also been set up as master trusts. In 2013, the Office of Fair Trading (OFT) reported that there were 44 master trusts established in the UK in 2012, and that the market was growing quickly.³¹ Some have roots in the occupational pension market. For example, The People’s Pension is set up by a not-for-profit organisation with a background in supplying employee benefits to the construction industry. Others have been established by insurance companies.³²
- 2.31 As we explore below, auto-enrolment will bring many new employers and employees to DC workplace pensions. It raises new challenges to ensure that such schemes offer good value for money.

PENSIONS REGULATION: A DUAL SYSTEM

- 2.32 For DC workplace schemes, trust-based and contract-based schemes perform a similar purpose. However, each is subject to a different system of law and regulation. Trust-based schemes are subject to trust law and regulated largely by The Pensions Regulator. Contract-based schemes are subject to contract law, and are regulated largely by the Financial Conduct Authority. Here we give a brief introduction to the main regulatory organisations. We also refer to the criticisms made of the dual regime.

The Pensions Regulator (TPR)

- 2.33 TPR is the main regulator for trust-based schemes. It has the following statutory objectives:
- (1) to protect the benefits of members of occupational pension schemes;
 - (2) to protect the benefits of members of personal pension schemes (where there is a direct payment arrangement);³³

²⁸ The Pensions Regulator, *Strategy for regulating defined contribution pension schemes* (October 2013) p 12.

²⁹ The legislation establishing NEST is contained in the Pensions Act 2008, Pt 1 Ch 5 and orders and regulations issued under this Act.

³⁰ Currently, the contribution charge is 1.8% and annual management charge is 0.3%. See <http://www.nestpensions.org.uk/schemeweb/NestWeb/public/NESTforSavers/contents/what-does-nest-cost.html>.

³¹ Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014) para 4.27.

³² Above, para 4.9.

³³ For the definition of direct payment arrangement, see para 8.37, footnote 43, below.

- (3) to promote, and to improve understanding of the good administration of work-based pension schemes;
 - (4) to reduce the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund; and
 - (5) to maximise employer compliance with employer duties and the employment safeguards introduced by the Pensions Act 2008. These duties include the duty to auto-enrol eligible employees.³⁴
- 2.34 From 14 July 2014, the Pensions Act 2014 will add an additional statutory objective to minimise any adverse impact on the sustainable growth of an employer when exercising its functions in relation to scheme funding.³⁵
- 2.35 TPR states that its approach is to educate and enable before resorting to enforcement action.³⁶ However, it also has extensive powers. These include powers to collect data,³⁷ to issue improvement notices,³⁸ and to issue contribution notices to employers who are believed to be avoiding their pension obligations.³⁹
- 2.36 TPR is also required to issue codes of practice. These provide practical guidance to trustees on how to comply with the requirements of pensions legislation, including how to make investment decisions. Codes of practice are not statements of the law and there is no penalty for failing to comply with them. However, if relevant they must be taken into account by the regulator, a court or tribunal, including the Pensions Ombudsman.⁴⁰

The Financial Conduct Authority (FCA)

- 2.37 As we discuss in Chapter 8, the FCA regulates contract-based pension providers. It also authorises the investment managers used by trust-based schemes, and firms that provide, promote and advise on personal pensions.
- 2.38 The interaction between TPR and the FCA is complex. All workplace schemes (both contract-based and trust-based) must register with TPR, which oversees payments by employers into the scheme.⁴¹ However, for contract-based schemes, FCA rules (rather than TPR) govern the way providers conduct their business.

³⁴ Pensions Act 2004, s 5.

³⁵ Pensions Act 2014, s 48.

³⁶ The Pensions Regulator, *Corporate plan 2013-2016* (May 2013) p 23.

³⁷ Pensions Act 2004, ss 63-64.

³⁸ Above, s 13.

³⁹ Above, s 38.

⁴⁰ Above, s 90(5); The Pensions Regulator, *Code of Practice No. 7: Trustee Knowledge and Understanding (TKU)* (November 2009) para 5.

⁴¹ See Pension Schemes Act 1993, s 111A and the Personal Pension Schemes (Payments by Employers) Regulations 2000 SI 2000 No 2692.

The Pension Protection Fund (PPF)

- 2.39 The PPF was introduced by the Pensions Act 2004.⁴² It is designed to protect members of DB schemes if their employer becomes insolvent on or after 6 April 2005, and there are insufficient assets in the scheme.⁴³ DB pension schemes pay a levy to the PPF which provides some of the funding for such protection. DC schemes are not eligible for protection.⁴⁴
- 2.40 If the member has attained the scheme's normal pension age at the date of insolvency, they will receive 100% of their entitlement. However, other members will only be entitled to 90%, and higher earners will receive less as compensation is subject to a cap.⁴⁵ Dependants are limited to 50% of the members' entitlement.⁴⁶

Ombudsman schemes

- 2.41 There are two ombudsman schemes which hear complaints about pensions. In practice, the Financial Ombudsman Service deals mainly with complaints about how pensions are sold. The Pensions Ombudsman deals mainly with complaints of maladministration.⁴⁷

Criticism of dual regulation

- 2.42 In the Consultation Paper we summarised some of the criticisms made of dual regulation by the Work and Pensions Select Committee, the National Audit Office and others.⁴⁸
- 2.43 The system is complex and may leave gaps in protection. As DC pensions may be set up under either trust or contract, the current system allows providers to choose their regulator. This leads to a risk that providers may choose the type of scheme which meets their short-term goals. The OFT has highlighted one example of such "regulator shopping", suggesting that some new entrants to the DC workplace pension market may have chosen master trust structures because they are subject to fewer prudential requirements.⁴⁹

⁴² Pensions Act 2004, Pt 2.

⁴³ There must be insufficient assets in the scheme to secure benefits on wind up that are at least equal to the compensation that the Pension Protection Fund would pay if it assumed responsibility for the scheme: Pensions Act 2004, s 127(2)(a).

⁴⁴ Pensions Act 2004, s 126(1)(a).

⁴⁵ For example, from 1 April 2014, at age 65 the effective cap is £32,761.07. The Pensions Act 2014 introduces an increased compensation cap for long service: see s 50; sch 20. For anyone with 21 years or more pensionable service, the cap will be increased by 3% of the standard amount for each full year over 20 years, to a maximum of double the standard amount.

⁴⁶ The calculation of this amount will differ depending on whether the member died before or after reaching the normal pension age of the scheme.

⁴⁷ For more detail of these schemes, see CP 215, Appendix B.

⁴⁸ CP 215 paras 13.61 to 13.68.

⁴⁹ Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014) para 4.24.

- 2.44 The Government believes the overall regulatory architecture is sound.⁵⁰ It is, however, introducing measures towards more common standards. In March 2014 it announced that new quality standards would apply across all DC workplace pension schemes.⁵¹

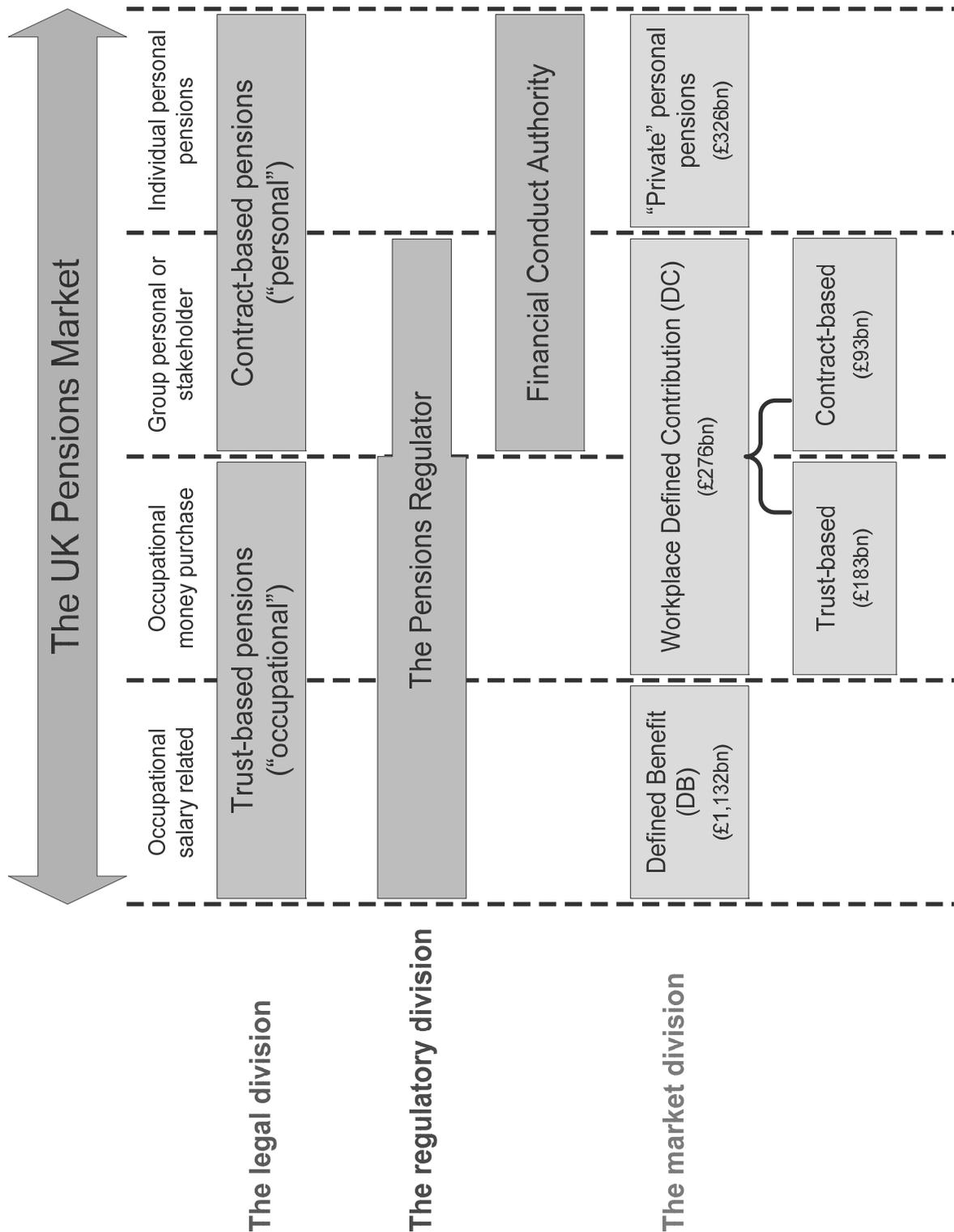
TYPES OF PENSION SCHEME: A SUMMARY

- 2.45 The various forms of pension provision are summarised in Figure 2.1. The division between trust-based and contract-based schemes is important from a legal and regulatory perspective, but it is less important to the market. There are many similarities between contract-based schemes and so called “bundled” trust schemes, where a single provider provides both administrative and fund management services to the scheme.

⁵⁰ Improving governance and best practice in workplace pensions: Government Response to the Committee’s Sixth Report of Session 2012-13, First Special Report of Session 2013-14 (2013-14) HC 485 p 8.

⁵¹ Better workplace pensions: Further measures for savers (2014) Cm 8840 p 10.

Figure 2.1: Summary of the various forms of pension provision.⁵²



⁵² Produced by reference to Spence Johnson, *Defined Contribution Market Intelligence* (2013) p 8. We are grateful to Spence Johnson for allowing the data to be reproduced. This diagram is intended only to be a general guide. We are aware, for example, that some personal pensions such as SIPPs may be trust-based. In addition, whilst contract-based pension schemes are subject to regulation by the FCA, all workplace schemes (both contract-based and trust-based) must register with TPR, which oversees payments by employers into the scheme: see para 2.38 above. Therefore, TPR is shown as having a more limited regulatory role for contract-based pensions than for trust-based pensions.

THE CHANGING NATURE OF OCCUPATIONAL PENSIONS

- 2.46 Pensions are subject to rapid economic, social and regulatory change, as the old DB schemes close and are replaced by DC schemes. Below we look briefly at the factors leading to a decline in DB schemes and a rise in DC schemes.

The decline of DB pensions

- 2.47 DB schemes are a dying breed. Rising life expectancy and low investment returns have significantly increased the cost to employers of offering these schemes. It is estimated that every one-year increase in life expectancy adds about £12 billion to the aggregate pension liabilities of FTSE 100 companies.⁵³ As schemes have gone into deficit, many employers have been required to make additional contributions.
- 2.48 As a result, many employers have closed DB schemes to new members. The National Association of Pension Funds' 2013 annual survey found that only 12% of private sector DB schemes remained open to new entrants.⁵⁴ Some schemes no longer allow further contributions from existing members, and some offer "enhanced transfer values" to encourage deferred members to transfer out of schemes.⁵⁵

Statutory funding obligations in DB scheme

- 2.49 DB schemes must show they are on track to meet their liabilities.⁵⁶ Every scheme is subject to a statutory funding objective which requires it to hold "sufficient and appropriate assets" to make provision for the scheme's liabilities.⁵⁷ Actuarial valuations to determine this amount must be prepared at least every three years.⁵⁸ In determining whether the scheme has "sufficient and appropriate assets", a current market rate value is given to the assets held.⁵⁹

⁵³ The Economist, "Running to stand still" (5 August 2006).

⁵⁴ NAPF, *Annual Survey 2013* (December 2013) p 6.

⁵⁵ Pensions Policy Institute, *The changing landscape of pension schemes in the private sector in the UK* (June 2012) p 35.

⁵⁶ The detailed rules governing how employers must fund their DB schemes are in the Pensions Act 2004 and the Occupational Pension Schemes (Scheme Funding) Regulations 2005 SI 2005 No 3377, and are supported by a code of practice: see The Pensions Regulator, *Regulatory Code of Practice 03: Funding defined benefits* (February 2006). In part, these obligations stem from the requirements of the Institutions for Occupational Retirement Provision (IORP) Directive 2003/41/EC, Official Journal L 235 of 23.09.2003 p 10.

⁵⁷ Pensions Act 2004, s 222.

⁵⁸ Above, s 224.

⁵⁹ This is known as a "mark-to-market" valuation.

- 2.50 Failure to meet the statutory funding objective requires the trustees to put a recovery plan in place, setting out the period over which the deficit is to be remedied. A copy must be sent to TPR.⁶⁰ TPR expects trustees to look to clear the deficit over a period that is appropriate for the schemes and in line with the affordability of the employer.⁶¹ The trustees are also required to ensure that the assumptions underlying the recovery plan are appropriate for the scheme.
- 2.51 We have been told that this has three effects:
- (1) Trustees' decision-making tends to focus on the actuarial valuations and the employer's obligation to fund the scheme. Actuaries therefore play a crucial role in the investment decisions trustees make.
 - (2) By generating a figure every three years (or less), investment decisions tend to be oriented to much shorter time horizons than the ultimate liabilities the scheme has to meet.
 - (3) When a valuation takes place assets are valued at current market values (known as mark-to-market valuations). This acts as a restraint on long-term thinking.
- 2.52 Any pension deficit must also be shown in the employer's company accounts, based on accounting standards FRS17⁶² or IAS19.⁶³ These accounting standards calculate pension fund liabilities in a different way from that taken by the statutory funding obligations,⁶⁴ for example in calculating life expectancies. Like the statutory funding objective, however, the accounting standards use current market values, which again focuses attention on the current rather than future value of pension assets.
- 2.53 The amount of the deficit shown on the accounts may be crucially important to an employer, as it is used as part of the process to determine whether the employer is solvent. A large deficit can significantly depreciate the net value of the employer's assets, and may become an obstacle to what would otherwise have been an advantageous takeover or merger. It is also likely to remain a drag on the employer's trading capacity.⁶⁵

⁶⁰ Pensions Act 2004, s 226.

⁶¹ The Pensions Regulator, *Draft code of practice no. 3: Funding defined benefits* (June 2014) paras 140-144.

⁶² Financial Reporting Standard 17.

⁶³ International Accounting Standard 19.

⁶⁴ Under the Occupational Pension Scheme (Scheme Funding) Regulations 2005 SI 2005 No 3377, reg 5, trustees are required to choose assumptions "prudently" but the accounting standard looks for a "best estimate". It has been suggested that this may lead to a different deficit figure: see D Pollard and C Magoffin, *Freshfields on Corporate Pensions Law* (1st ed 2013) p 26.

⁶⁵ D Fox, *Defined Benefit Pension Trusts: Asset Partitioning and the Residual Interest* (November 2010) pp 5-6.

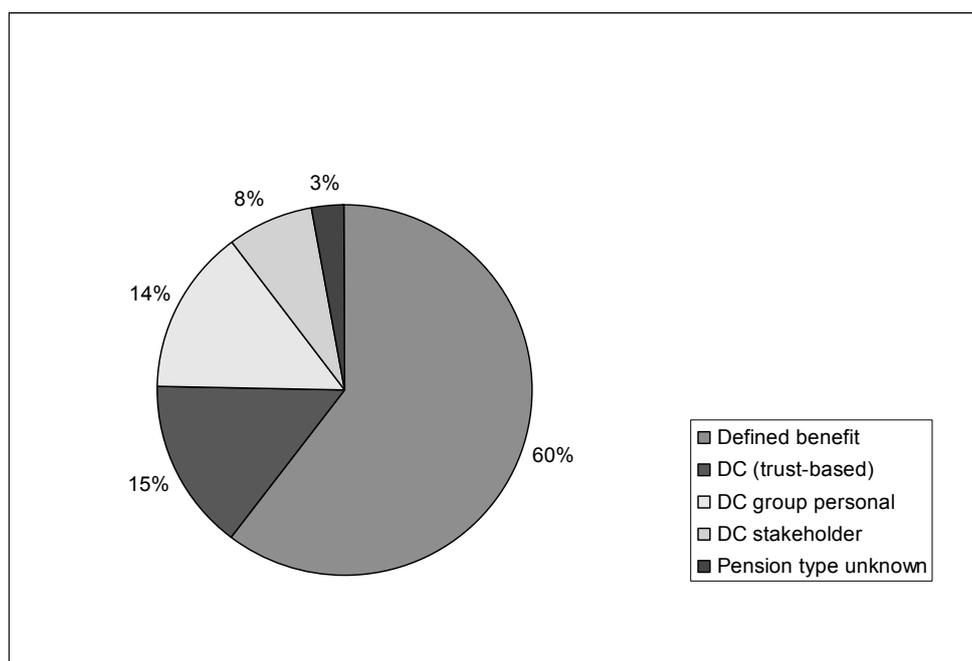
The growth of DC schemes

- 2.54 DC schemes are “the growth story of pensions”.⁶⁶ It is estimated that there are currently 7.9 million memberships in DC schemes.⁶⁷
- 2.55 There are two main drivers of this growth. First, employers who previously offered DB pensions are now offering DC pensions instead. Secondly, automatic enrolment brought many new people into a workplace pension. The Pensions Regulator estimates that, since the introduction of auto-enrolment, more than 3 million employees have been auto-enrolled across more than 10,000 employers.⁶⁸ DWP estimates that, when fully phased-in, auto-enrolment will increase the number of individuals newly saving or saving more in a workplace pension by around eight million, and increase the amount that is being saved in workplace pensions by around £11 billion per year.⁶⁹

The changes in graphs

- 2.56 These changes can be illustrated in the following graphs. Figure 2.2, below, shows that in 2012, 60% of active members of occupational pension schemes were still in DB schemes, and a further 15% were in trust-based DC schemes. The role of pension trustees is, therefore, still crucial to UK pensions policy.

Figure 2.2: Employee membership of an occupational pension scheme, by pension type (2012).



Source: Office for National Statistics, Pension Trends, Chapter 7: Private Pension Scheme Membership, 2013 Edition (16 July 2013).

⁶⁶ M Harrison, “Coming of age?” (July 2013) *Pensions World* 1 at 1.

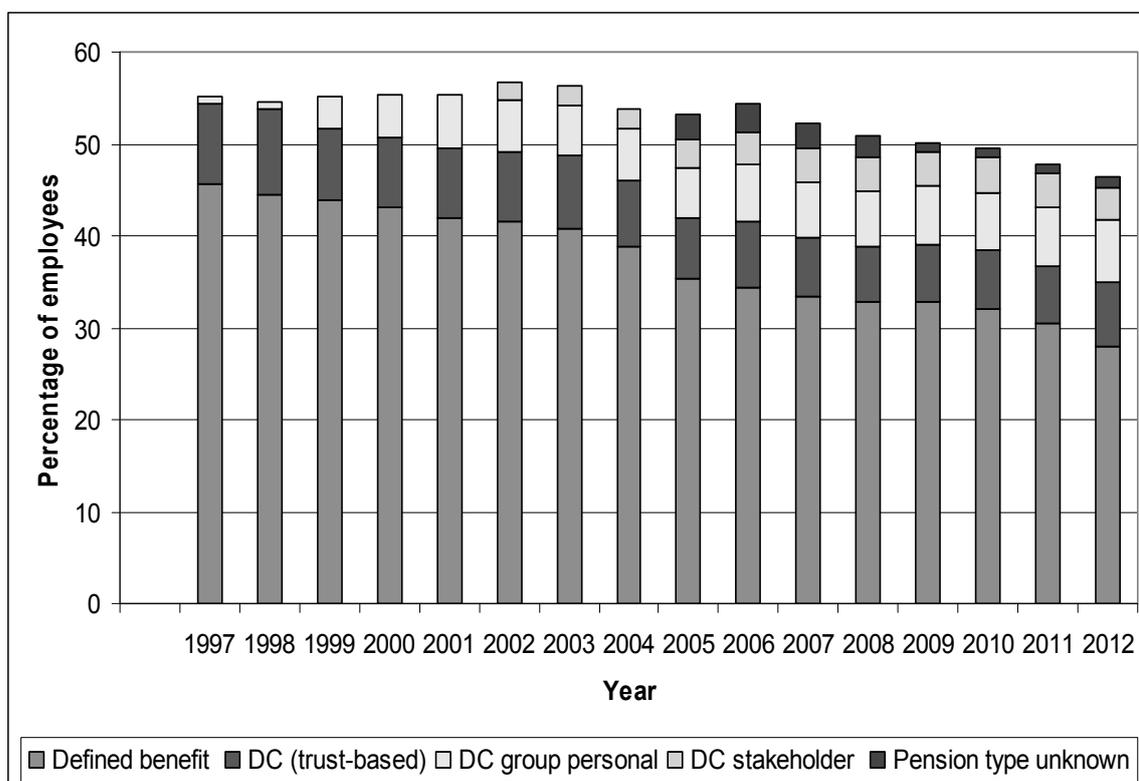
⁶⁷ Spence Johnson, *Defined Contribution Market Intelligence* (2013) p 14.

⁶⁸ The Pensions Regulator, *Automatic enrolment: Registration report* (May 2014).

⁶⁹ Department for Work and Pensions, *Automatic Enrolment evaluation report 2013* (November 2013) p 3.

2.57 However, these proportions are changing rapidly. Figure 2.3 shows the steady decline in DB membership and a rise in contract-based stakeholder and personal schemes – a trend which will accelerate with auto-enrolment. It is estimated that DC assets will exceed DB assets by 2022.⁷⁰

Figure 2.3: Employee membership of an occupational pension scheme, by pension type (1997 to 2012).



Source: Office for National Statistics, Pension Trends, Chapter 7: Private Pension Scheme Membership, 2013 Edition (16 July 2013).

2.58 The graph shows that in 2012 fewer than half of employees were active members of a workplace pension scheme. Some may be making private provision, but most are not. With the introduction of auto-enrolment, membership of pension schemes will increase, but the level of contributions required by auto-enrolment is much lower than for DB schemes. Those born after 1980 are unlikely to receive anything like the final salary pensions enjoyed by the baby boomer generation.

⁷⁰ Investment & Pensions Europe, *Fiduciary management: A catalyst for growth* (1 October 2012), available at http://www.ipe.com/magazine/fiduciary-management-a-catalyst-for-growth_47675.php.

Defined ambition: a middle ground?

- 2.59 DWP has been working on plans to introduce a new type of pension provision, known as “defined ambition”. These schemes are designed to seek a middle ground between defined benefit schemes, where the employer bears all the investment risk, and defined contribution schemes, where investment risk is borne solely by the employee. In November 2012, DWP published *Reinvigorating workplace pensions*,⁷¹ where it examined the case for greater risk-sharing in pension schemes. DWP commented:

With risk currently sitting with employers (DB) or employees (DC), the Government is keen to explore the scope for new types of scheme which share risk (‘Defined Ambition’). A Defined Ambition pension would seek to give greater certainty for members than a DC pension about the final value of their pension pot and less cost volatility for employers than a DB pension.⁷²

- 2.60 Together with Industry Working Groups, the DWP has now outlined several scheme designs, looking at ways to introduce increased flexibility in DB schemes, and increased certainty in DC schemes.

PENSION CHALLENGES

- 2.61 The rapid changes to the pension landscape have led to many challenges, as DB schemes have gone from surplus to deficit and contract-based schemes require new forms of regulation. Here we outline those challenges, and some of the proposals for reform that have recently been announced.

Charges

- 2.62 The charge levied by a pension provider can have an enormous effect on how much pensioners ultimately receive on retirement. A recent report estimated that each percentage point increase in the total expense ratio may lead to a fall in income at retirement of about 20%. In other words, assume that two similar employees invest the same money in a pension, but one invests in a scheme charging 0.5% of fund each year while the other invests in a scheme charging 1.5%. As a rough rule of thumb, the second employee will receive a pension which is 20% lower than the first. The report found that the impact of charges was much more important than the investment strategy.⁷³

⁷¹ *Reinvigorating workplace pensions* (2012) Cm 8478.

⁷² Above, p 4. See also *Reshaping workplace pensions for future generations* (2013) Cm 8710.

⁷³ D Harrison, D Blake and K Dowd, *VfM: assessing value for money in defined contribution default funds* (January 2014) p 13. See also OECD, *Pensions Outlook* (June 2012) p 175.

- 2.63 Following many criticisms of excessive charging by pension providers,⁷⁴ the OFT investigated the issue in depth, looking at both contract-based and bundled trust schemes. Its report, in September 2013, concluded that “the buyer side of the DC workplace pensions market is one of the weakest that the OFT has analysed in recent years”.⁷⁵ Employees fail to engage with pensions while employers do not have the capability or incentive to drive competition.
- 2.64 Prior to 2001, the industry levied a wide variety of charges: annual percentage charges were supplemented by initial charges, ongoing fixed charges, early surrender penalties and other one off charges. In 2001, the industry moved toward levying a single percentage charge, known as the Annual Management Charge (AMC). There is now more competition based on this visible AMC. However, problems remain: “legacy” schemes remain open to new members and charge well over the odds, and there is no consistent means of calculating AMCs across the industry.⁷⁶
- 2.65 Following the OFT’s report, the Government has now announced that it plans to introduce a charge cap. Transaction costs will not be capped but will have to be disclosed. We discuss these proposals in more detail in Chapter 9.⁷⁷

Governance

- 2.66 Ensuring effective governance for pension schemes remains a challenge. Whilst trust-based schemes benefit from a clear governing body in the form of the trustees, there are particular concerns that smaller trust-based schemes are failing to meet the Regulator’s standards. We discuss these issues in Chapter 9.⁷⁸
- 2.67 Recent reports have also raised concerns about the quality of governance in contract-based schemes.⁷⁹ In its recent review of workplace pension schemes, the Work and Pensions Select Committee concluded:

⁷⁴ See, for example, The Pensions Institute, *Caveat Venditor: The brave new world of auto-enrolment should be governed by the principle of seller not buyer beware* (October 2012); Fabian Society, *Pensions at Work, that Work: Completing the unfinished pensions revolution* (May 2013).

⁷⁵ Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014) para 1.9.

⁷⁶ See para 9.11 below.

⁷⁷ See paras 9.43 to 9.46 below.

⁷⁸ See paras 9.14 to 9.15 below.

⁷⁹ See, for example, FairPensions (later known as ShareAction), *Whose duty? Ensuring effective stewardship in contract-based pensions* (July 2012); Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014); The Pensions Institute, *Caveat Venditor: The brave new world of auto-enrolment should be governed by the principle of seller not buyer beware* (October 2012).

There are inherent weaknesses in the mechanisms for governing contract-based schemes which the Government and the regulators must address, to ensure that members of contract-based schemes are offered the same level of protection from detriment as members of trust-based schemes.⁸⁰

- 2.68 The Government has announced that it intends to introduce minimum quality standards for all workplace pension schemes. In particular, all workplace schemes must be governed by a body with a duty to act in members' interests. That body must also have, or have access to, all of the resources, knowledge and competencies necessary to run the scheme properly.
- 2.69 In addition, the Government has also introduced new governance standards for contract-based schemes, building on the agreement between the Association of British Insurers (ABI) and the OFT to embed Independent Governance Committees (IGCs) within all providers of contract-based and bundled trust-based schemes.⁸¹ The remit of IGCs will be to act in members' interests through assessing and reporting on a scheme's value for money.⁸² We discuss the Government's proposed reforms to governance and the introduction of IGCs in Chapter 9.

Scale

- 2.70 The trust-based pensions market in the UK is highly fragmented. In initial discussions, stakeholders expressed concern that many UK pension schemes were too small. In 2013 TPR reported that, of 6,150 PPF-eligible defined benefit schemes,⁸³ 2,209 have fewer than 100 members.⁸⁴
- 2.71 The size of a pension scheme can have an influence on how effectively it is governed and how able it is to protect members' interests. Economies of scale may bring benefits in terms of lower administration and fund management charges and more control over those who make investment decisions on behalf of the fund. It also makes engagement with investee companies financially viable and practically possible. We return to this issue in Chapter 9.⁸⁵

⁸⁰ Improving governance and best practice in workplace pensions, Sixth Report of the Select Committee on Work and Pensions (2012-13) HC 768-I para 27.

⁸¹ Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014) para 7.52.

⁸² Better workplace pensions: Further measures for savers (2014) Cm 8840 p 38.

⁸³ This excludes: unfunded public sector schemes; some funded public sector schemes; schemes to which a Minister of the Crown has given a guarantee; and schemes which began to wind up, or were completely wound up, prior to 6 April 2005. This list is not exhaustive: see Pensions Act 2004, s 126 and Pension Protection Fund (Entry Rules) Regulations 2005 SI 2005 No 590, reg 2.

⁸⁴ These figures are from the Purple Book 2013 dataset and are based on scheme returns from 6,150 DB schemes, representing around 99% of all PPF-eligible schemes. See Pension Protection Fund and The Pensions Regulator, *The Purple Book: DB Pensions Universe Risk Profile* (November 2013) p 24.

⁸⁵ See paras 9.26 to 9.29 below.

2.72 DWP recently examined the risk that small funds may fail to provide good governance, investment expertise, and low costs. It recognised that small DC schemes did pose risks, but thought that the risks were diminishing as schemes consolidated. It pointed out that many small schemes were run by large insurance companies, who provided the benefits of scale in the way they invested. It also predicted that small employers would not set up new small schemes but would instead buy into larger schemes. The Government has said that it is addressing the lack of benefits of scale that may exist in some schemes through its work on strengthening governance, improving transparency and controlling charges. It concluded that the benefits of scale would be delivered by the market and ongoing regulatory activity and that there was not a case for further legislative intervention by the Government. However, the Government has said that it will continue to consider additional non-legislative activity.⁸⁶

A COMPARISON WITH AUSTRALIA

2.73 It is interesting to compare the structure of UK pensions with the Australian system. In the course of this project, we commissioned a paper from a leading Australian law firm, Clayton Utz, which is available in Appendix C of the Consultation Paper.

2.74 As in the UK, Australian pensions have a trust structure which derives from English law. They have also moved from DB to DC schemes. However, there are some significant differences. All schemes must be trust-based under a single regulatory regime. Furthermore, the market is much more consolidated, following changes in legislation that have encouraged schemes to scale up. Over half of all funds under management are now held by the largest twenty pension schemes.⁸⁷

CONCLUSION

2.75 Pension policy faces many challenges. At present most UK workplace pension schemes are trust-based, but this is changing rapidly. Auto-enrolment will lead to growth in contract-based schemes. Concerns have been expressed about how contract-based schemes are regulated. The current system puts the emphasis on individuals to monitor their holdings over time, but people may lack the skills to do this effectively.

2.76 Meanwhile, in traditional DB schemes, as many trustees focus on reducing deficits, there is pressure to produce short-term results. We have been told that many of the factors which shape pension trustees' investment decisions do not concern the law. Other pressures are more acute, including those produced by statutory funding objectives and accounting calculations based on mark-to-market valuations. Furthermore, many trust-based pension schemes are small, and in practice many trustees are highly reliant on others in the investment chain.

⁸⁶ Better workplace pensions: Further measures for savers (2014) Cm 8840 p 39.

⁸⁷ Australian Prudential Regulation Authority, "Superannuation industry overview" (Issue 1, 2013) *Insight* p 10.

CHAPTER 3

FIDUCIARY DUTIES WITHIN THE LEGAL FRAMEWORK

- 3.1 In this Chapter we provide a short overview of fiduciary duties, placing them within the matrix of the other legal regimes governing financial markets. Fiduciary duties cannot be understood in isolation. Instead they are better viewed as “legal polyfills”, moulding themselves flexibly around other legal structures, and sometimes plugging the gaps.
- 3.2 This Chapter has three strands, We start by outlining some of the multiple sources of law governing financial markets. This puts the role of “judge-made” duties in context.
- 3.3 We then provide a short introduction to the concept of fiduciary duties. We explain that the phrase has different meanings. We describe who is subject to fiduciary duties, what fiduciary duties consist of, and how they may be modified by contract.
- 3.4 The third strand looks at other “judge-made” duties which run alongside fiduciary duties in the strict sense. Although fiduciary duties are often equated with the duty to act in the interest of another, they tell only half the story. Fiduciary duties focus on what a fiduciary should *not* do, rather than what they should do. Positive duties derive from other sources, most notably from duties attaching to the exercise of a power and from duties of care. Therefore we also summarise the duties that attach to a power and provide a brief outline of duties of care.

MULTIPLE SOURCES OF LAW

- 3.5 As we explained in the Consultation Paper, financial markets are governed by a great deal of law, arising from at least four separate sources.¹
 - (1) **Agreements by the parties.** The starting point is often the contract agreed by the parties. Freedom of contract is a fundamental value of English and Scots law. Where market participants are considered to be sophisticated commercial parties, the courts will be reluctant to interfere with their commercial arrangements. Similarly, when organisations are set up as trusts, the powers and constraints on trustees are often set out in the trust deed.
 - (2) **Financial Conduct Authority (FCA) rules.** These are central to the way UK financial markets work, reflecting both domestic and European Union policy decisions. They are set out in the various components of the FCA Handbook, which is a complex database of rules and guidance.

¹ For further discussion see CP 215, Chapter 4.

- (3) **Pensions legislation.** This differs between trust-based pensions and contract-based pensions. Where pensions are trust-based, the investment decisions of pension trustees are governed by the Pensions Acts 1995 and 2004, together with the regulations made under these Acts. For example, regulations require that the investment of assets is “in the best interests of the beneficiaries” and in a manner “calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole”.² The 1995 Act also obliges trustees to prepare and maintain a “statement of investment principles”.³
- (4) **“Judge-made” law.** Participants are also subject to the legal duties found in case law, as developed by judges over the centuries. Lawyers think in terms of different branches of law, distinguishing (for example) between the law of trusts, tort⁴ and contract. The Consultation Paper outlined three separate types of “judge-made law” relevant to this area: fiduciary duties; duties that attach to the exercise of a power; and duties of care.
- 3.6 Each of these sources may both impose and modify duties of market participants to act in the interests of another.

The inter-relationship between these sources

- 3.7 The legal regimes imposed by these sources are often complex in themselves and are even more complex in their inter-relationships. They have been developed by different entities with different objectives, so it is unsurprising that there are often tensions between them. For example, the regulatory regime may be more pragmatic in dealing with conflicts of interest or undisclosed commissions than legal principles would suggest, leading Professor Kay to accuse regulators of “watering down” fiduciary duties.⁵ Meanwhile, commercial parties often seek to escape liabilities through contract terms.
- 3.8 Nevertheless, to answer practical questions about legal duties in financial markets, it is often necessary to draw on three or four different types of law. For example, to understand the investment duties of pension trustees it is necessary to start with the pensions legislation and the trust deed, before considering fiduciary duties, duties that attach to the exercise of a power and duties of care.
- 3.9 Similar complexities arise when considering the duties of other parties in the investment chain to act in the interest of their customers or end investors. Take a case in which it is argued that a bank should have given advice about whether an investment is suitable. Again, the court will have regard to multiple factors: it will start by looking at the contract documents and FCA rules, before considering possible duties of care and fiduciary obligations.

² Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 4.

³ Pensions Act 1995, s 35.

⁴ Or delict in Scotland.

⁵ J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012) para 9.13.

This Chapter

- 3.10 The Consultation Paper included a general introduction to the FCA rules and to the pensions legislation, which we do not repeat here.⁶ Below we concentrate on “judge-made” duties: fiduciary duties; duties that attach to the exercise of a power; and duties of care.

THE MEANINGS OF FIDUCIARY DUTY

- 3.11 As we have seen, the term “fiduciary duty” means different things to lawyers and non-lawyers. Even lawyers use the term in different ways. In part, this reflects changes in judicial thinking about what the term means.⁷
- 3.12 In the past, the term “fiduciary duty” has been used in a broad sense to cover all the various duties a fiduciary owes. However, the courts have now issued stern warnings against using the term in this way. It has now been recognised that fiduciaries will owe both fiduciary duties and non-fiduciary duties. Only those duties that are peculiar to fiduciaries are properly termed fiduciary duties.⁸ It follows that not every breach of duty by a fiduciary is a breach of fiduciary duty.⁹ As Lord Justice Millett noted in *Bristol and West Building Society v Mothew*:

This branch of the law has been bedevilled by unthinking resort to verbal formulae. It is therefore necessary to begin by defining one’s terms. The expression “fiduciary duty” is properly confined to those duties which are peculiar to fiduciaries and the breach of which attracts legal consequences differing from those consequent upon the breach of other duties. Unless the expression is so limited it is lacking in practical utility.¹⁰

⁶ See CP 215, Chapters 7 to 8.

⁷ *Aequitas v AEFC* [2001] NSWSC 14 at [283].

⁸ *Bristol and West Building Society v Mothew* [1998] Ch 1 at 16; *Breen v Williams* (1996) 186 CLR 74 at 137. See also *Snell’s Equity* (32nd ed 2010) para 7-009; M Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties* (2010). The *Mothew* case is frequently cited in Scotland: see, for example, *Commonwealth Oil & Gas Co Ltd v Baxter* 2010 SC 156.

⁹ *Bristol and West Building Society v Mothew* [1998] Ch 1 at 16; *AG v Blake* [1998] Ch 439 at 455; *John Youngs Insurance Services Ltd v Aviva Insurance Service UK Ltd* [2011] EWHC 1515 (TCC) at [94]; *Ocular Sciences Ltd v Aspect Vision Care Ltd* [1997] RPC 289 at 413; *Base Metal Trading Ltd v Shamurin* [2004] EWCA Civ 1316 at [19]; *Hilton v Barker Booth & Eastwood* [2005] UKHL 8 at [29]; *Lac Minerals Ltd v International Corona Resources Ltd* (1989) 61 DLR (4th) 14 at 28; *Girardet v Crease & Co* (1987) 11 BCLR (2d) 361 at 362; *Permanent Building Society (in liq) v Wheeler* (1994) 14 ACSR 109 at 157; *Roberts v R* (2002) 220 DLR (4th) 1 at [83].

¹⁰ *Bristol and West Building Society v Mothew* [1998] Ch 1 at 16.

- 3.13 The distinguishing duty of a fiduciary is “the duty of loyalty”.¹¹ However, this duty of loyalty sits alongside the other statutory, equitable and common law duties which a fiduciary might owe. For example, a duty to exercise reasonable care and skill is not a fiduciary duty.¹² As the House of Lords noted in *Hilton v Barker Booth & Eastwood*:

If a solicitor is careless in investigating a title or drafting a lease, he may be liable to pay damages for breach of his professional duty, but that is not a breach of a fiduciary duty of loyalty; it is simply the breach of a duty of care.¹³

WHO IS SUBJECT TO FIDUCIARY DUTIES?

- 3.14 This is a “notoriously intractable” question,¹⁴ and is far from settled. A former Chief Justice of the High Court of Australia has said that the “fiduciary relationship is a concept in search of a principle.”¹⁵ What is relatively clear is that fiduciary relationships arise in two main circumstances:

- (1) *Status-based fiduciaries* – where a relationship falls within a previously recognised category, such as a solicitor and client;¹⁶ and
- (2) *Fact-based fiduciaries* – where the particular facts and circumstances of a relationship justify the imposition of fiduciary duties.¹⁷

¹¹ *Bristol and West Building Society v Mothew* [1998] Ch 1 at 18.

¹² Above, at 16-17; *Permanent Building Society v Wheeler* (1994) 14 ACSR 109 at 158.

¹³ *Hilton v Barker Booth & Eastwood* [2005] UKHL 8 at [29].

¹⁴ E Weinrib, “The Fiduciary Obligation” (1975) 25(1) *University of Toronto Law Journal* 1 at 5.

¹⁵ A Mason, “Themes and Prospects” in P Finn (ed), *Essays in Equity* (1985) 242 at 246.

¹⁶ There is a strong, yet rebuttable, presumption that fiduciary duties will be owed in such relationships: *Lac Minerals Ltd v International Corona Resources Ltd* (1989) 61 DLR (4th) 14 at 28.

¹⁷ *Chirnside v Fay* [2006] NZSC 68 at [75]. See also *Snell’s Equity* (32nd ed 2010) para 7-005.

- 3.15 Status-based fiduciary relationships are those that are recognised, by their very nature, as inherently fiduciary.¹⁸ They represent the settled categories of fiduciary relationship. They include the relationships between: trustee and beneficiary,¹⁹ principal and agent,²⁰ mortgagee and mortgagor,²¹ solicitor and client,²² company directors and the company;²³ partners and co-partners;²⁴ and civil servants and the Crown.²⁵
- 3.16 The categories of fiduciary relationship are not closed.²⁶ However, the difficulty lies in identifying the circumstances which justify the imposition of fiduciary duties. The courts have traditionally declined to provide a clear definition, preferring to preserve flexibility.²⁷ In 1992, we said that the test is based on “discretion, power to act and vulnerability”,²⁸ though different commentators have characterised the appropriate test in different ways.

¹⁸ *Chirnside v Fay* [2006] NZSC 68 at [73].

¹⁹ *Keech v Sandford* (1726) Sel Cas Ch 61; *Price v Blakemore* (1843) 6 Beav 507. For Scots law see *Gloag & Henderson, The Law of Scotland* (13th ed 2012) para 41.15.

²⁰ *De Busshe v Alt* (1878) 8 Ch D 286; *Kirkham v Peel* (1880) 43 LT 171; *Lamb v Evans* [1893] 1 Ch 218; *New Zealand Netherlands Society Oranje Inc v Kuys* [1973] 1 WLR 1126; *English v Dedham Vale Properties Ltd* [1978] 1 WLR 93; *Korkontzilas v Soulos* (1997) 146 DLR (4th) 214. For Scots law see *Gloag & Henderson, The Law of Scotland* (13th ed 2012) para 18.04; L Macgregor, *The Law of Agency in Scotland* (1st ed 2013) ch 6; *Parks of Hamilton Ltd v Campbell* [2014] CSIH 36.

²¹ *Farrars v Farrars Ltd* (1888) 40 Ch D 395. Scots law has not characterised the relationship between a debtor and a secured creditor as fiduciary but at common law there are obligations upon the creditor which have a fiduciary look to them: see *Gloag & Henderson, The Law of Scotland* (13th ed 2012) para 36.04(7). Note also that the proceeds of a sale under a standard security are held by the creditor on trust: Conveyancing and Feudal Reform (Scotland) Act 1970, s 27.

²² *Re Hallet's Estate* (1880) 13 Ch D 696; *McMaster v Bryne* [1952] 1 All ER 1362; *Brown v IRC* [1965] AC 244; *Oswald Hickson Collier & Co v Carter-Ruck* [1984] AC 720; *Swindle v Harrison* [1997] 4 All ER 705; *Logstaff v Birtles* [2001] EWCA Civ 1219; *Conway v Ratiu* [2005] EWCA Civ 1302. For Scots law see L Macgregor, *The Law of Agency in Scotland* (1st ed 2013) paras 6.26-6.28.

²³ *Sinclair v Brougham* [1914] AC 398; *Regal (Hastings) v Gulliver* [1967] 2 AC 134; *Selangor United Rubber Estates Ltd v Craddock* (No 3) [1968] 1 WLR 1555; *Industrial Development Consultants Ltd v Cooley* [1972] 1 WLR 443; *Cowan de Groot Properties Ltd v Eagle Trust plc* [1992] 4 All ER 700; *Item Software (UK) Ltd v Fassihi* [2004] EWCA 1244. For Scots law see *Gloag & Henderson, The Law of Scotland* (13th ed 2012) para 46.33; *Dryburgh v Scott Media Tax Ltd (in liquidation)* [2014] CSIH 45.

²⁴ *Bentley v Craven* (1853) 18 Beav 75; *Aas v Benham* [1891] 2 Ch 244; *Thompson's Trustee in Bankruptcy v Heaton* [1974] 1 WLR 605. For Scots law see *Gloag & Henderson, The Law of Scotland* (13th ed 2012) para 45.18.

²⁵ *Reading v Attorney-General* [1951] AC 507; *Attorney-General v Guardian Newspapers Ltd (No 2)* [1990] 1 AC 109; *Attorney-General for Hong Kong v Reid* [1994] 1 AC 324; *Attorney-General v Blake* [1998] Ch 439.

²⁶ *Tate v Williamson* (1866) LR 2 Ch App 55 at 61; *English v Dedham Vale Properties Ltd* [1978] 1 WLR 93 at 110; *Guerin v Canada* [1984] 2 SCR 335 at 384; *Schipp v Cameron* [1998] NSWSC 997 at [695].

²⁷ *Lloyds Bank Ltd v Bundy* [1975] QB 326 at 341; *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41 at 96 and 141.

²⁸ Fiduciary Duties and Regulatory Rules (1992) Law Commission Consultation Paper No 124 para 2.4.6.

An undertaking to act for or on behalf of another person

- 3.17 Several academics have emphasised the importance of an undertaking to act on behalf of another as the touchstone of a fiduciary relationship. It has been said that a fiduciary “is, simply, someone who undertakes to act for or on behalf of another in some particular matter or matters”.²⁹ In his seminal work *Fiduciary Obligations*, Paul Finn said that:

For a person to be a fiduciary he must first and foremost have bound himself in some way to protect and/or to advance the interests of another. This is perhaps the most obvious of the characteristics of the fiduciary office for Equity will only oblige a person to act in what he believes to be another’s interests if he himself has assumed a position which requires him to act for or on behalf of that other in some particular matter.³⁰

- 3.18 This view has judicial support. In *Bristol and West Building Society v Mothew*, Lord Justice Millett said that:

A fiduciary is someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence.³¹

Legitimate expectations

- 3.19 A similar view, building on the idea of an undertaking, is that:

What must be shown ... is that the actual circumstances of a relationship are such that one party is *entitled to expect* that the other will act in his interests in and for the purposes of the relationship. Ascendancy, influence, vulnerability, trust, confidence or dependence doubtless will be of importance in making this out, but they will be important only to the extent that they evidence a relationship suggesting that entitlement.³²

- 3.20 This view has growing judicial support. The Privy Council has noted that:

The [fiduciary] concept encaptures a situation where one person is in a relationship with another which gives rise to a legitimate expectation, which equity will recognise, that the fiduciary will not utilise his or her position in such a way which is adverse to the interests of the principal.³³

²⁹ P Finn, *Fiduciary Obligations* (1977) para 467. See also A Scott, “The Fiduciary Principle” (1948-1949) 37(4) *California Law Review* 539 at 540; L Sealy, “Fiduciary Relationships” [1962] *Cambridge Law Journal* 69 at 72-79.

³⁰ P Finn, *Fiduciary Obligations* (1977) para 15.

³¹ [1998] Ch 1 at 18. See also *Breen v Williams* (1996) 186 CLR 74 at 137-138.

³² P Finn, “The Fiduciary Principle” in T Youdan (ed), *Equity, Fiduciaries and Trusts* (1989) 1 at 46 (emphasis added).

³³ *Arklow Investments Ltd v Maclean* [2000] 1 WLR 594 at 598.

Vulnerability and discretion

3.21 In the Canadian case of *Frame v Smith*, Madam Justice Bertha Wilson said that:

Relationships in which a fiduciary obligation have been imposed seem to possess three general characteristics: (1) The fiduciary has scope for the exercise of some discretion or power. (2) The fiduciary can unilaterally exercise that power or discretion so as to affect the beneficiary's legal or practical interests. (3) *The beneficiary is peculiarly vulnerable to or at the mercy of the fiduciary holding the discretion or power.*³⁴

3.22 Whilst vulnerability remains important, the courts now tend to see it as an indicator of fiduciary status, rather than its defining feature. In *Hodgkinson v Simms*, the Supreme Court of Canada said that although "the concept of vulnerability is not the hallmark of fiduciary relationship" it was an important indicator of its existence.³⁵ Similarly, in *Hospital Products Ltd v United States Surgical Corp* Justice Mason noted that whilst the primary test is whether there is an undertaking or agreement by the fiduciary to act for or on behalf of or in the interests of another person, it is:

partly because the fiduciary's exercise of the power or discretion can adversely affect the interests of the person to whom the duty is owed and because the latter is at the mercy of the former that the fiduciary comes under a duty to exercise his power or discretion in the interests of the person to whom it is owed.³⁶

Reconciling these approaches

3.23 James Edelman has argued that the courts are moving to coalesce the factors of trust, vulnerability, confidence, power and/or discretion into a single test based upon the legitimate expectations of the principal.³⁷ The focus of this approach is on the undertaking: did the putative fiduciary, by his words or conduct, give rise to an understanding or expectation in a reasonable person that they would behave in a particular way.³⁸ As Edelman notes:

The greater the degree of trust, vulnerability, power and confidence reposed in the fiduciary, the more likely that a reasonable person would have such an expectation.³⁹

³⁴ [1987] 2 SCR 99 at 136 (emphasis added).

³⁵ *Hodgkinson v Simms* [1994] 3 SCR 377 at 405, by La Forest J.

³⁶ *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41 at 97.

³⁷ J Edelman, "When do fiduciary duties arise?" (2010) 126 *Law Quarterly Review* 302.

³⁸ Above, at 317-318. See also P Finn, "The Fiduciary Principle" in T Youdan (ed), *Equity, Fiduciaries and Trusts* (1989) 1 at 46.

³⁹ J Edelman, "When do fiduciary duties arise?" (2010) 126 *Law Quarterly Review* 302 at 317.

- 3.24 We think that this is a useful way to determine when fiduciary relationships arise. The key test is whether there is a legitimate expectation that one party will act in another's interest. However, discretion, power to act and vulnerability are indicators of such an expectation.

THE CONTENT OF FIDUCIARY DUTIES

- 3.25 It is not only uncertain when fiduciary duties arise, it is also uncertain what fiduciary duties require. In our 1992 Consultation Paper we described fiduciary obligations as "highly complex, poorly delimited, and in a state of flux".⁴⁰ We quoted Lord Justice Fletcher Moulton in *Re Coomber*:

There is no class of case in which one ought more carefully to bear in mind the facts of the case, when one reads the judgment of the Court on those facts, than cases which relate to fiduciary and confidential relations and the action of the Court with regard to them.⁴¹

- 3.26 Furthermore, not all fiduciaries owe the same fiduciary duties.⁴² Some relationships may give rise to more onerous duties than others, and duties may be modified by contract, or read subject to regulatory rules.

The duty of loyalty

- 3.27 As we noted above, the distinguishing duty of a fiduciary is the duty of loyalty.⁴³ As Lord Justice Millett noted in *Bristol and West Building Society v Mothew*:

The principal is entitled to the single-minded loyalty of his fiduciary. This core liability has several facets. A fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal. This is not intended to be an exhaustive list, but it is sufficient to indicate the nature of fiduciary obligations. They are the defining characteristics of the fiduciary.⁴⁴

A breach of fiduciary obligation, therefore, "connotes disloyalty or infidelity".⁴⁵

⁴⁰ Fiduciary Duties and Regulatory Rules (1992) Law Commission Consultation Paper No 124 para 2.4.1.

⁴¹ [1911] 1 Ch 723 at 729.

⁴² *Henderson v Merrett Syndicates Ltd* [1995] 2 AC 145 at 206.

⁴³ *Bristol & West Building Society v Mothew* [1998] Ch 1 at 18

⁴⁴ Above, at 18.

⁴⁵ Above.

3.28 In our 1992 Consultation Paper we divided the duty of loyalty into four categories.⁴⁶ However, it may be simpler to consider two main themes:

- (1) *the “no conflict rule”* – a fiduciary must avoid acting where there is a conflict between their duty and their interest (a “duty-interest” conflict), and also where there is a conflict between duties owed to multiple principals (a “duty-duty” conflict).⁴⁷
- (2) *the “no profit rule”* – a fiduciary must not make an unauthorised profit by reason or in virtue of the fiduciary office or otherwise within the scope of that fiduciary office.

3.29 However, fiduciaries will not breach these rules if they have the proper authorisation.⁴⁸ This can take several forms:

⁴⁶ Fiduciary Duties and Regulatory Rules (1992) Law Commission Consultation Paper No 124 para 2.4.9. In 1992 we listed the duty of confidentiality as a fiduciary duty but it is unlikely that a court will now consider it as such. In *Arklow Investments Ltd v Maclean* [2000] 1 WLR 594 at 600, the court noted that “it is essential not to confuse [fiduciary duties] with the separate duty to respect confidential information”. It is also clear that obligations of confidentiality are not “peculiarly” fiduciary: see, for example, *Indata Equipment Supplies Ltd v ACL Ltd* [1998] FSR 248 at 256; *Cadbury Schweppes Inc v FBI Foods Ltd* (1999) 167 DLR (4th) 577; *Oceanic Life Ltd v HIH Casualty & General Insurance Ltd* [1999] NSWSC 292 at [44]; *Lac Minerals Ltd v International Corona Resources Ltd* (1989) 61 DLR (4th) 14. We also listed duty-interest and duty-duty conflicts separately. We now believe that these are better treated as “separate but cognate” parts of the “no conflict” rule: see M Conaglen, “Fiduciary regulation of conflicts between duties” (2009) 125 *Law Quarterly Review* 111 at 140. For an example of both being treated as part of the “no conflict” rule, see *In Plus Group Ltd v Pyke* [2002] EWCA Civ 370 at [71].

⁴⁷ The relevant “conflict” for the purposes of the “no conflict” rule is a conflict between a fiduciary’s non-fiduciary duties to their principal and their personal interest, or a conflict between a fiduciary’s non-fiduciary duties to one principal and their non-fiduciary duties to another principal. There can, therefore, be no breach of the “no conflict” rule if there is no non-fiduciary duty in the circumstances: *In Plus Group Ltd v Pyke* [2002] EWCA Civ 370 at [76] and [90]; *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638 (Ch) at [1308]–[1310] and [1330].

⁴⁸ See *Snell’s Equity* (32nd ed 2010) paras 7-014-7-015; *Bowstead & Reynolds on Agency* (19th ed 2010) para 6-039.

- (1) *Principal's consent* – a principal may choose to allow a fiduciary to act in a way that would otherwise be a breach of fiduciary duty by giving their fully informed consent.⁴⁹ There “is no precise formula” for what amounts to fully informed consent; it is a question of fact in the circumstances of each case.⁵⁰ However, the courts will often look carefully for clear evidence⁵¹ that the fiduciary made “full and frank disclosure of all material facts”.⁵² It is not sufficient merely to disclose that the fiduciary has an interest,⁵³ or to make statements that would put the principal on inquiry.⁵⁴ Nor is it a defence for the fiduciary to assert that if they had asked for permission it would have been given.⁵⁵
- (2) *Prior authorisation* – authorisation may come from the person who created the fiduciary relationship. For example, a trust instrument may authorise a conflict⁵⁶ or profit.⁵⁷
- (3) *Court sanction* – the court has the power to sanction a transaction which would otherwise constitute a breach of fiduciary duty.⁵⁸

⁴⁹ *Boardman v Phipps* [1967] 2 AC 46 at 109; *Clark Boyce v Mouat* [1994] 1 AC 428 at 435; *Bristol and West Building Society v Mothew* [1998] Ch 1 at 18; *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Ltd (ACN 113 114 832) (No.4)* [2007] FCA 963 at [293]. For Scots law see *Gloag & Henderson, The Law of Scotland* (13th ed 2012) para 3.03. In Scots law, the beneficiaries may authorise acts of the trustee otherwise in breach of the latter's fiduciary duty, but departure from the trust deed generally requires authorisation by the court: see *Gloag & Henderson, The Law of Scotland* (13th ed 2012) paras 41.09, 41.15. The Trusts (Scotland) Act 1921, s 4 (as amended) confers a wide range of powers that trustees may exercise so long as the acts are not at variance with the trust terms or purposes. But a third party dealing with trustees apparently exercising section 4 powers need not inquire into the actual trust terms or purposes to make the transaction effective (Trusts (Scotland) Act 1961, s 2(1)). This will not however affect liability to beneficiaries or co-trustees if the transaction was beyond these actual powers.

⁵⁰ *Maguire v Makaronis* (1997) 188 CLR 449 at 466; *Commonwealth Bank of Australia v Smith* (1991) 102 ALR 453 at 477-478.

⁵¹ *York & North-Midland Railway Co v Hudson* (1845) 16 Beav 485 at 491; *Coles v Trecothick* (1804) 9 Ves Jr 234 at 246-247.

⁵² *New Zealand Netherlands Society “Oranje” Inc v Kuys* [1973] 1 WLR 1126 at 1132, by Lord Wilberforce.

⁵³ *Imperial Mercantile Credit Association Co v Coleman* (1873) LR 6 HL 189; *Dunne v English* (1874) LR 18 Eq 524 at 535; *Hurstanger Ltd v Wilson* [2007] EWCA Civ 299 at [35]; *FHR European Ventures LLP v Mankarious* [2011] EWHC 2308 (Ch) at [78] (this aspect of the decision was not affected by the related appeal [2013] EWCA Civ 17).

⁵⁴ *Dunne v English* (1874) LR 18 Eq 524 at 535; *Novoship (UK) Ltd v Mikhaylyuk* [2012] EWHC 3586 (Comm) at [83].

⁵⁵ *Murad v al-Saraj* [2005] EWCA Civ 959 at [129]; *Gray v New Augarita Porcupine Mines Ltd* [1952] 3 DLR 1 at 15.

⁵⁶ *Edge v Pensions Ombudsman* [2000] Ch 602 at 621-622 and 632-633; *Re Thompson's Settlement* [1986] Ch 99 at 115.

⁵⁷ *Space Investments Ltd v Canadian Imperial Bank of Commerce Trust Co (Bahamas) Ltd* [1986] 1 WLR 1072 at 1075; *Brown v IRC* [1965] AC 244 at 256; *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638 (Ch) at [1318].

⁵⁸ *Campbell v Walker* (1800) 5 Ves Jr 678 at 681; *Farmer v Dean* (1863) 32 Beav 327; *Holder v Holder* [1968] Ch 353 at 398 and 402.

The “no conflict” rule

DUTY-INTEREST CONFLICTS

3.30 Fiduciaries may not, without proper authorisation, put themselves into a position where their interest and duty conflict.

3.31 The rule against duty-interest conflicts will only be breached if a reasonable person “looking at the relevant facts and circumstances of the particular case would think that there was a real sensible possibility of conflict”.⁵⁹ The duty is strict; the honesty of the fiduciary is irrelevant,⁶⁰ as is whether the fiduciary’s gain was one that the principal could or could not have obtained,⁶¹ since a breach of fiduciary duty “may be attended with perfect good faith”.⁶² It can be breached even where the conflict benefits the principal in some way.⁶³ Similarly, it is not necessary to show that there has been a breach of non-fiduciary duty in order for there to have been a breach of fiduciary duty.⁶⁴

3.32 The classic case is the decision of the House of Lords in *Aberdeen Railway Co v Blaikie Bros*,⁶⁵ which concerned a contract between a partnership and a railway company for the manufacture and supply of certain iron chairs for use on the railway. Mr Blaikie was, at the time of the contract, both the managing partner of the partnership and a director and chairman of the railway company. A dispute arose and the partnership sued on the contract. The claim failed. Mr Blaikie’s duty to the company was to procure the chairs as cheaply as possible; his personal interest was in selling them as expensively as possible. Lord Chancellor Lord Cranworth noted that:

it is a rule of universal application, that no one having [fiduciary] duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect. So strictly is this principle adhered to, that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into.⁶⁶

The House of Lords held that, because of this conflict, the railway company was entitled to avoid the contract.

⁵⁹ *Boardman v Phipps* [1967] 2 AC 46 at 124, by Lord Upjohn.

⁶⁰ *Ex parte James* (1803) 8 Ves Jr 337 at 345 and 348; *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461 at 475; *De Bussche v Alt* (1878) 8 Ch D 286 at 316; *Boston Deep Sea Fishing & Ice Co v Ansell* (1888) 39 Ch D 339 at 369; *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134 at 144-145.

⁶¹ *Boston Deep Sea Fishing & Ice Co v Ansell* (1888) 39 Ch D 339 at 355 and 367; *Costa Rica Railway Co Ltd v Forwood* [1901] 1 Ch 746 at 760-761; *Industrial Development Consultants Ltd v Cooley* [1972] 1 WLR 443 at 453.

⁶² *Bray v Ford* [1896] AC 44 at 48.

⁶³ *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461 at 472; *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134 at 153; *Boardman v Phipps* [1967] 2 AC 46 at 129.

⁶⁴ See *Hamilton v Wright* (1842) 9 Cl & Fin 111 at 123, where it was said that “it is quite enough that the thing which he does has ... a tendency to interfere with his duty.”

⁶⁵ (1854) 1 Macq 461.

⁶⁶ Above, at 471.

DUTY-DUTY CONFLICTS

- 3.33 A fiduciary must not, without proper authorisation, act for two principals to whom they owe conflicting duties. There is no need for the duties the fiduciary owes each principal to be actually in conflict; it is enough if the fiduciary “puts himself in a position where his duty to one principal *may* conflict with his duty to the other.”⁶⁷ In *Farrington v Rowe McBride & Partners*, a solicitor advised a client to invest money in a company which was also a client of his, without disclosing that fact to the potential investor. The court held that:

A solicitor's loyalty to his client must be undivided. He cannot properly discharge his duties to one whose interests are in opposition to those of another client. If there is a conflict in his responsibilities to one or both he must ensure that he fully discloses the material facts to both clients and obtains their informed consent to his so acting And there will be some circumstances in which it is impossible, notwithstanding such disclosure, for any solicitor to act fairly and adequately for both.⁶⁸

- 3.34 As this passage makes clear, obtaining the principals' fully informed consent to continue acting is not the end of the issue. The fiduciary must act in good faith in the interests of each principal and must not act with the intention of furthering the interests of one principal to the prejudice of those of the other.⁶⁹ In addition, the fiduciary “must take care not to find himself in a position where there is an *actual* conflict of duty so that he cannot fulfil his obligations to one principal without failing in his obligations to the other.”⁷⁰ A fiduciary in this position will generally have to cease acting for one principal, and preferably both.⁷¹

The “no profit” rule

- 3.35 A fiduciary must not make an unauthorised profit by reason of their fiduciary position.⁷² As the High Court of Australia noted in *Chan v Zacharia*, a fiduciary is required:

to account for any benefit or gain obtained or received by reason of or by use of his fiduciary position or of opportunity or knowledge resulting from it.⁷³

A fiduciary will be in breach of the rule even where there is no possible disadvantage to the principal.⁷⁴ Honesty is no defence,⁷⁵ and it is irrelevant whether the principal could have obtained the profit for itself.⁷⁶

⁶⁷ *Bristol and West Building Society v Mothew* [1998] Ch 1 at 18 (emphasis in original).

⁶⁸ [1985] 1 NZLR 83 at 90, by Richardson J. This passage was cited by Lord Jauncey, giving the judgment of the Privy Council, in *Clark Boyce v Mouat* [1994] 1 AC 428 at 436.

⁶⁹ *Bristol & West Building Society v Mothew* [1998] Ch 1 at 19.

⁷⁰ Above, at 19 (emphasis in original). For an example see *Marks & Spencer Plc v Freshfields Bruckhaus Deringer* [2004] EWHC 1337 (Ch).

⁷¹ *Bristol & West Building Society v Mothew* [1998] Ch 1 at 19.

⁷² *Boardman v Phipps* [1967] 2 AC 46; *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134. The rule may apply even if there is no conflict between the fiduciary and principal: *Oceanic Life Ltd v HIH Casualty & General Insurance Ltd* [1999] NSWSC 292 at [42].

⁷³ (1984) 154 CLR 178 at 198.

3.36 In *Regal (Hastings) Ltd v Gulliver*,⁷⁷ the directors of a company (Regal) formed a subsidiary so that the company could acquire two new cinemas. However, Regal was unable to raise sufficient finance to capitalise the subsidiary fully. To enable the acquisition to proceed, the directors subscribed for shares in the subsidiary themselves. These shares were later sold at a profit. The House of Lords unanimously held that the directors were liable to account to Regal for this profit. Lord Russell explained that the basis of this liability was:

... that the directors standing in a fiduciary relationship to Regal in regard to the exercise of their powers as directors, and having obtained these shares by reason and only by reason of the fact that they were directors of Regal and in the course of the execution of that office, are accountable for the profits which they have made out of them.⁷⁸

Modifying fiduciary duties

3.37 The existence of a fiduciary relationship does not in itself determine the content of the duties owed by a fiduciary to their principal.⁷⁹ As noted above, a principal may choose to allow a fiduciary to act in a way that would otherwise be a breach of fiduciary duty.⁸⁰

⁷⁴ *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134 at 144-145; *Foster Bryant Surveying Ltd v Bryant* [2007] EWCA Civ 200 at [88] and [101].

⁷⁵ *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134 at 144-145.

⁷⁶ Above, at 144, 149 and 159; *Boardman v Phipps* [1967] 2 AC 46 at 109; *Cobbetts LLP v Hodge* [2009] EWHC 786 (Ch) at [104].

⁷⁷ [1967] 2 AC 134.

⁷⁸ Above, at 149.

⁷⁹ *News Limited v Australian Rugby Football League Limited* [1996] FCA 870 at 158.

⁸⁰ See para 3.29 above.

3.38 However, it is also open to the parties to a contract to exclude or modify the operation of fiduciary duties.⁸¹ The contract is the starting point.⁸² The courts have acknowledged that fiduciary duties will be “moulded according to the nature of the relationship and the facts of the case”.⁸³ In *Hospital Products Ltd v United States Surgical Corporation*, Justice Mason said:

That contractual and fiduciary relationships may co-exist between the same parties has never been doubted. Indeed, the existence of a basic contractual relationship has in many situations provided a foundation for the erection of a fiduciary relationship. In these situations it is the contractual foundation which is all important because it is the contract that regulates the basic rights and liabilities of the parties. The fiduciary relationship, if it is to exist at all, must accommodate itself to the terms of the contract so that it is consistent with, and conforms to, them. The fiduciary relationship cannot be superimposed upon the contract in such a way as to alter the operation which the contract was intended to have according to its true construction.⁸⁴

3.39 In *Kelly v Cooper*, the Privy Council applied this analysis. The claimant instructed the defendant estate agent to sell his house. The owner of the adjacent house also instructed the same estate agent. The agent received an offer for both houses, but did not inform the claimants that their purchaser was also interested in buying the house next door. The claimant argued that they could have obtained a higher price for their house if they had known the purchaser was interested in both houses, and that the defendant had put themselves in a position where their duty to the claimant to disclose all relevant information pertaining to the sale conflicted with their personal interest in obtaining commission on both sales. Lord Browne-Wilkinson thought that the contract came first:

First, agency is a contract made between principal and agent; second, like every other contract, the rights and duties of the principal and agent are dependent upon the terms of the contract between them, whether express or implied. It is not possible to say that all agents owe the same duties to their principals: it is always necessary to have regard to the express or implied terms of the contract.⁸⁵

⁸¹ *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Ltd (ACN 113 114 832) (No.4)* [2007] FCA 963 at [278]. For a discussion of Scots law on this topic see L Macgregor, *The Law of Agency in Scotland* (1st edn 2013) paras 6.55-6.56.

⁸² *Fattal v Walbrook Trustees (Jersey) Ltd* [2010] EWHC 2767 (Ch) at [113].

⁸³ *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41 at 102. See also *New Zealand Netherlands Society “Oranje” Inc v Kuys* [1973] 1 WLR 1126 at 1129-1130; *Kelly v Cooper* [1993] AC 205 at 214-215.

⁸⁴ *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41 at 97. This passage was cited with approval by the Privy Council in *Kelly v Cooper* [1993] AC 205 at 215.

⁸⁵ *Kelly v Cooper* [1993] AC 205 at 213-214.

- 3.40 Lord Browne-Wilkinson emphasised that “estate agents must be free to act for several competing principals otherwise they will be unable to perform their function”,⁸⁶ and that customers of an estate agent would know that the agent would also act for vendors of comparable properties. He concluded that the contract included an implied term that the agent was entitled to act for other principals selling competing properties and to keep confidential the information obtained from each.⁸⁷ *Kelly* is therefore authority for the proposition that fiduciary duties may be modified by both the express and implied terms of the contract.⁸⁸

A duty to act “in the best interests” of the principal?

- 3.41 Fiduciary duties are traditionally considered to proscribe conduct rather than prescribe it.⁸⁹ They tell fiduciaries what they should not do, rather than what they should do. As the Supreme Court of Victoria noted in *P & V Industries Pty Ltd v Porto*:

This means that the no conflict and no profit rules encompass the whole content of fiduciary obligations and the duty of loyalty imposed on a fiduciary is promoted by prohibiting disloyalty rather than by prescribing some positive duty.⁹⁰

- 3.42 Thus fiduciary duties support other duties. In particular, the duty to avoid conflicts is said to guard against a fiduciary’s temptation to breach other duties.⁹¹

⁸⁶ *Kelly v Cooper* [1993] AC 205 at 214.

⁸⁷ Above, at 214-215.

⁸⁸ See also *John Alexander’s Clubs Pty Ltd v White City Tennis Club Ltd* [2010] HCA 19 at [91]-[92]; D Frase, *Law and Regulation of Investment Management* (2nd ed 2011) para 8-069.

⁸⁹ *Attorney-General v Blake* [1998] Ch 439 at 455; *Breen v Williams* (1996) 186 CLR 71 at 95, 113 and 137-138; *Pilmer v Duke Group Ltd (in liq)* [2001] HCA 31 at [74] and [127]; *Youyang Pty Ltd v Minter Ellison Morris Fletcher* [2003] HCA 15 at [41]; *Aequitas v AEFC* [2001] NSWSC 14 at [278]-[284].

⁹⁰ [2006] VSC 131 at [23].

⁹¹ *Boston Deep Sea Fishing & Ice Co v Ansell* (1888) 39 Ch D 339 at 357, by Cotton LJ; *Harrods Ltd v Lemon* [1931] 2 KB 157 at 162 (affirmed on appeal [1931] 2 KB 157 at 168); *Eden v Ridsdales Railway Lamp & Lighting Co Ltd* (1889) 23 QBD 368 at 371; M Conaglen, “The Nature and Function of Fiduciary Loyalty” (2005) 121 *Law Quarterly Review* 452 at 453 and 480.

- 3.43 In Chapter 5 we discuss pension trustees' duties to act in the "best interests" of scheme members. This is best thought of as a combination of existing duties rather than as a duty in its own right.⁹² It has been described as "essentially an umbrella duty—one which embraces a large number of individual, well-recognised duties".⁹³ Lord Nicholls, writing extra-judicially, has suggested that to define a trustee's obligation in terms of acting in the best interests of 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.⁹⁴ Below we look at trustees' duties to further the purpose of the trust.

DUTIES CONNECTED TO THE EXERCISE OF A POWER

What is a "power"?

- 3.44 Broadly speaking, a "power" refers to the ability to alter legal relations between parties.⁹⁵ Powers are by their nature discretionary, and the law has developed ways of controlling this discretion to prevent abuse.
- 3.45 Powers may be given to a wide range of people, and the duties attached to them may be categorised in different ways. For example, liquidators have a statutory power to sell a company's property so that they can obtain the funds necessary to satisfy the claims of the company's creditors.⁹⁶ For the purposes of this report we focus on powers given to trustees,⁹⁷ especially powers to invest. Here we discuss six duties which the courts in England & Wales have developed to guide and constrain trustees' powers. The position in Scotland is considered more briefly below.⁹⁸

⁹² J Lehane, "Delegation of Trustees' Powers and Current Developments in Investment Funds Management" (1995) 7(1) *Bond Law Review* 36 at 38.

⁹³ G Thomas, "The Duty of Trustees to Act in the 'Best Interests' of their Beneficiaries (2008) 2 *Journal of Equity* 177 at 202.

⁹⁴ Lord Nicholls, "Trustees and their Broader Community: Where Duty, Morality and Ethics Converge" (1996) 70 *Australian Law Journal* 205 at 211.

⁹⁵ W Hohfeld, *Fundamental Legal Conceptions As Applied in Judicial Reasoning* (1st ed 1919) p 50-51. In *Re Armstrong* (1886) 17 QBD 521 at 531, Fry LJ defined a power as "an individual personal capacity of the donee of the power to do something".

⁹⁶ In a compulsory liquidation, this power is contained in the Insolvency Act 1986, sch 4, para 6.

⁹⁷ The duties discussed here only apply in respect of fiduciary powers: *Lewin on Trusts* (18th ed 2012) para 29-138. Whether or not a power is a fiduciary power will depend on its construction. If a power may be exercised by its holder for the holder's own purposes—on his own behalf, if not necessarily for his own benefit—the power will be non-fiduciary: *Re Wills Trust Deeds* [1964] Ch 219 at 228. There is a presumption that powers given to trustees are fiduciary in nature even if they involve a very wide discretion (although it is possible to rebut the presumption): *Re Smith* [1904] 1 Ch 139. Unlike donees of a fiduciary power, donees of a non-fiduciary power are not accountable for what they do with the power provided they act, if at all, within its scope: *Snell's Equity* (32nd ed 2010) para 10-009.

⁹⁸ See paras 3.66 to 3.67 below.

1. Trustees should act within the scope of their powers

- 3.46 Trustees must act within the terms of their powers. This means, for example, abiding by any condition or restriction in the trust deed. Going beyond the permitted bounds of a power is known as “excessive execution”.⁹⁹ It is “an attempt to go beyond that which is authorized by the express or implied terms of the particular power or by law”.¹⁰⁰
- 3.47 The scope of a power is an issue of construction. Examples of excessive execution include the inclusion of persons who, or purposes which, are not proper objects of the power, and a failure to comply with any restriction or condition imposed on the power which is being exercised.¹⁰¹

2. Trustees should not exercise a power “fraudulently”

- 3.48 Trustees must not exercise a power improperly.¹⁰² This doctrine is known by a variety of names, including “fraudulent execution”, “fraud on a power” and “improper purposes”.
- 3.49 The use of the word “fraud” may be misleading. As Lord Parker explained in *Vatcher v Paull*, it merely means that:

the power has been exercised for a purpose, or with an intention, beyond the scope of or not justified by the instrument creating the power.¹⁰³

- 3.50 This element of fraudulent execution, namely going beyond the scope of the relevant power, is common to both excessive execution and fraudulent execution. In both cases, a power can only be exercised for the purpose for which it was conferred. The distinguishing feature of fraudulent execution is “a deliberate breach of the implied obligation not to exercise that power for an ulterior purpose”.¹⁰⁴

3. Trustees should not act under the dictation of another

- 3.51 A power is given to an individual personally. Any exercise of that power must be a personal and conscious act of that individual and not dictated by another: the “law does not permit him to be another’s puppet”.¹⁰⁵

⁹⁹ See *Pitt v Holt* [2013] UKSC 26 at [60].

¹⁰⁰ G Thomas and A Hudson, *The Law of Trusts* (2nd ed 2010) para 18.01.

¹⁰¹ *Thomas on Powers* (2nd ed 2012) para 8.01.

¹⁰² This principle is of considerable pedigree: see *Aleyn v Belchier* (1758) 1 Eden 132.

¹⁰³ [1915] AC 372 at 378.

¹⁰⁴ *Thomas on Powers* (2nd ed 2012) para 9.02.

¹⁰⁵ P Finn, *Fiduciary Obligations* (1st ed 1977) para 42.

- 3.52 This does not preclude trustees from taking advice, as long as they make the ultimate decision. As Mr Justice Robert Walker noted in *Scott v National Trust*:

Trustees must act in good faith, responsibly and reasonably. They must inform themselves, before making a decision, of matters which are relevant to the decision. These matters may not be limited to simple matters of fact but will, on occasion (indeed, quite often) include taking advice from appropriate experts, whether the experts are lawyers, accountants, actuaries, surveyors, scientists or whomsoever. It is however for advisers to advise and for trustees to decide: trustees may not (except in so far as they are authorised to do so) delegate the exercise of their discretions, even to experts. This sometimes creates real difficulties, especially when lay trustees have to digest and assess expert advice on a highly technical matter (to take merely one instance, the disposal of actuarial surplus in a superannuation fund).¹⁰⁶

- 3.53 Similarly, the duty means that trustees cannot act at the dictation of their beneficiaries.¹⁰⁷ However, they are not precluded from consulting their beneficiaries,¹⁰⁸ or from following beneficiaries' instructions, provided they do not do so blindly without exercising their own judgement.¹⁰⁹ A leading textbook notes that:

Trustees may inquire what are the wishes and opinions of others, especially of those who are interested, before finally determining what, in the exercise of their own discretion, they think expedient, and will not be held to act against their own judgment if they should in the end disregard objections to which they had previously given weight.¹¹⁰

- 3.54 However, the courts will not permit dialogue to be transported into dictation.¹¹¹ Nor are trustees under a specific duty to consult beneficiaries, unless this is expressly provided for by the trust instrument or by statute.¹¹²

4. Trustees should not fetter their discretion

- 3.55 Trustees should not bind themselves or their successors about how they will or will not exercise a power in the future.¹¹³ A "fetter" is wrong because it obliges the trustee to exercise their discretion:

¹⁰⁶ [1998] 2 All ER 705 at 717.

¹⁰⁷ See for example *Selby v Bowie* (1863) 8 LT 372 (a beneficiary cannot insist that trustees accept a particular offer to purchase trust property) and *Re Brockbank* [1948] Ch 206 (a beneficiary cannot insist that trustees appoint a particular person as trustee).

¹⁰⁸ See for example *Re Agricultural Industries* [1952] 1 All ER 1188 at 1190.

¹⁰⁹ See *Thomas on Powers* (2nd ed 2012) para 10.60, citing *Re Poole* (1882) 21 Ch D 397 at 404; *Re Smith ex parte Brown* (1886) 17 QBD 488; *Wilson v Turner* (1883) 22 Ch D 521. See also P Finn, *Fiduciary Obligations* (1st ed 1977) para 44.

¹¹⁰ *Lewin on Trusts* (18th ed 2012) para 29-89, citing *Fraser v Murdoch* (1881) 6 App Cas 855 at 864-865, by Lord Selborne LC.

¹¹¹ P Finn, *Fiduciary Obligations* (1st ed 1977) para 45.

¹¹² *X v A* [2000] 1 All ER 490 at 496.

in a specified manner to be decided by considerations other than his own conscientious judgment *at the time* as to what is best in the interests of those for whom he is trustee.¹¹⁴

3.56 This means that any undertaking about how a trustee will exercise a power in the future is ineffective.¹¹⁵

5. Trustees should treat beneficiaries and objects even-handedly

3.57 Trustees must be impartial in the execution of their trust.¹¹⁶ As Lord Justice Turner said in *Re Tempest*:

It is of the essence of the duty of every trustee to hold an even hand between the parties interested under the trust. Every trustee is in duty bound to look to the interests of all, and not of any particular member or class of members of his *cestuis que trusts* [beneficiaries].¹¹⁷

3.58 There are two aspects to this duty:

- (1) members of the same class of beneficiaries or objects ought to be treated equally; and
- (2) members of different classes of beneficiaries or objects ought to be treated fairly.

¹¹³ *Snell's Equity* (32nd ed 2010) para 10-016.

¹¹⁴ *Osborne v Amalgamated Society of Railway Servants* [1909] 1 Ch 163 at 187, by Fletcher Moulton LJ (emphasis added).

¹¹⁵ *Lewin on Trusts* (18th ed 2012) para 29-204. The exact consequence of an improper fetter will depend on the form of the fetter: see P Finn, *Fiduciary Obligations* (1st ed 1977) paras 66-70.

¹¹⁶ It is unclear to what extent this duty applies to donees of fiduciary powers other than trustees. A leading textbook takes the view that the mere fact that the power is fiduciary, however, must of itself imply that the duty does apply: *Lewin on Trusts* (18th ed 2012) para 29-165. The duty has also been discussed in the context of other fiduciaries: see *Henry v Great Northern Railway* (1857) 1 De G & J 606 at 638 (company directors); *Re Newdigate Colliery Co* [1912] 1 Ch 478 (court appointed receivers).

¹¹⁷ (1886) 1 Ch App 485 at 487-488.

3.59 Traditionally, it was said that in relation to investment, trustees should “hold the scales equally” between different classes of beneficiary. In *Nestle v National Westminster Bank*,¹¹⁸ Mr Justice Hoffmann preferred to say that the trustee must act fairly in making investment decisions which may have different consequences for different classes of beneficiaries. He explained that investment was not a “mechanistic process” but required trustees to act fairly in a more general sense:

Investments will carry current expectations of their future market yield and capital appreciation and these expectations will be reflected in their current market price, but there is always a greater or lesser risk that the outcome will deviate from those expectations. A judgment on the fairness of the choices made by the trustees must have regard to these imponderables.¹¹⁹

3.60 In this case, the interests of a person with a life interest (the “tenant for life”) had to be balanced against the person who would inherit the capital after their death (“the remainderman”). The trustees had a wide discretion to take into account multiple factors. Mr Justice Hoffmann noted:

They are for example entitled to take into account the income needs of the tenant for life or the fact that the tenant for life was a person known to the settlor and a primary object of the trust whereas the remainderman is a remoter relative or a stranger. Of course these cannot be allowed to become the overriding considerations but the concept of fairness between classes of beneficiaries does not require them to be excluded. It would be an inhuman law which required trustees to adhere to some mechanical rule for preserving the real value of the capital when the tenant for life was the testator’s widow who had fallen on hard times and the remainderman was young and well off.¹²⁰

3.61 The duty has also been applied in relation to trustees of occupational pension schemes. For example, it has been held that, in exercising their discretion over surplus funds, trustees are bound to exercise their powers fairly as between the beneficiaries.¹²¹ Similarly, when making transfer payments from one scheme to another, trustees must ensure that they are acting fairly as between the employees remaining in the pension fund, and those who will be transferred.¹²²

¹¹⁸ (1996) 10(4) Trust Law International 112.

¹¹⁹ Above, at 115.

¹²⁰ Above, at 115-116.

¹²¹ *UEB Industries Ltd v WS Brabant* [1991] Pens LR 109 at 116.

¹²² *Stannard v Fisons Pension Trust Ltd* [1991] Pens LR 225 at [22].

6. Trustees should take into account relevant considerations and ignore irrelevant considerations

- 3.62 When exercising their powers, trustees must take into account all relevant considerations and ignore any irrelevant considerations. This is the duty of adequate deliberation, and concerns the nature of trustees' decision-making process rather than the scope of the power itself.¹²³
- 3.63 There are no "hard and fast rules" as to what might be relevant.¹²⁴ It is fairly well settled that the tax consequences of a decision will usually be relevant.¹²⁵ As Mr Justice Patten stated in *Abacus Trust Co (Isle of Man) v NSPCC*:

The financial consequences for the beneficiaries of any intended exercise of a fiduciary power cannot be assessed without reference to their fiscal implications. The two seem to me inseparable.¹²⁶

- 3.64 The Supreme Court has now confirmed that the rule about relevant and irrelevant considerations will only apply if the trustees' inadequate deliberation was sufficiently serious so as to amount to a breach of fiduciary duty:

It is not enough to show that the trustees' deliberations have fallen short of the highest possible standards, or that the court would, on a surrender of discretion by the trustees, have acted in a different way.¹²⁷

¹²³ See R Nolan, "Controlling fiduciary power" (2009) 68(2) *Cambridge Law Journal* 293 at 306.

¹²⁴ G Thomas and A Hudson, *The Law of Trusts* (2nd ed 2010) para 11.59.

¹²⁵ *Karger v Paul* [1984] VR 161; *Abacus Trust Co (Isle of Man) Ltd v NSPCC* [2001] STC 1344 at [16]-[17]; *Pitt v Holt* [2013] UKSC 26 at [65].

¹²⁶ [2001] STC 1344 at [16].

¹²⁷ *Pitt v Holt* [2013] UKSC 26 at [73]. The rule itself has also been described as a "fiduciary duty": see *Pitt v Holt* [2011] EWCA Civ 197 at [127]. In this context, however, the term is being used broadly and encompasses duties other than those which are "peculiarly fiduciary", such as the rules prohibiting unauthorised conflicts of duty and interest and the rule prohibiting unauthorised profits. Here the term means "the duties incumbent on a fiduciary to perform his office": R Nolan and A Cloherty, "The rule in *Pitt v Holt*?" (2011) 127 *Law Quarterly Review* 499 at 501.

- 3.65 Further, there is unlikely to be a breach if the trustees obtain and act upon apparently competent professional advice. In other words, a trustee will not breach this duty if, having identified the relevant considerations and used all proper care and diligence in obtaining the relevant information and advice, it turns out that the information was partial or incorrect.¹²⁸ The court stated:

If in exercising a fiduciary power trustees have been given, and have acted on, information or advice from an apparently trustworthy source, and what the trustees purport to do is within the scope of their power, the only direct remedy available (either to the trustees themselves, or to a disadvantaged beneficiary) must be based on mistake (there may be an indirect remedy in the form of a claim against one or more advisers for damages for breach of professional duties of care).¹²⁹

The law in Scotland

- 3.66 The cases mentioned above are not binding in Scotland, although they are of persuasive value. Under Scots law, a challenge to the exercise of fiduciary power by trustees appears possible under the common law on the following grounds: consideration by the trustees of the wrong question; a failure of the trustees to apply their minds to the right question; the trustees' perversely shutting their eyes to the facts; or trustees' failure to act honestly or in good faith.¹³⁰ These grounds are influenced by the law concerning judicial review of administrative action, and are somewhat more comprehensive than those recognised in England. The Scottish Law Commission has consulted on a suggestion that a statutory right to challenge the exercise of fiduciary powers should be granted,¹³¹ based on the common law grounds, and will be reporting in 2014.
- 3.67 Furthermore, in Scotland a court may relieve a trustee from personal liability for breach of trust, where the trustee is considered to have acted honestly and reasonably and ought fairly to be excused.¹³² This will not aid a negligent trustee but may provide relief for one in breach of a fiduciary duty or acting beyond its powers.¹³³

¹²⁸ [2013] UKSC 26 at [40]-[41].

¹²⁹ Above, at [41]. Later in the judgment, at [90], the court commented that the possibility of a claim for damages should have no effect on the operation of trustees' duty to take account of relevant considerations.

¹³⁰ *Dundee General Hospitals v Bell's Trustees* 1952 SC (HL) 78 at 92; 1952 SLT 270 at 275.

¹³¹ Scottish Law Commission, Consultation Paper on Defects in the Exercise of Fiduciary Powers (2011).

¹³² Trusts (Scotland) Act 1921, s 32.

¹³³ The rule is discussed in Scottish Law Commission Discussion Paper No 123 on Breach of Trust (2003) Part 6.

DUTIES OF CARE

- 3.68 Duties of care arise in the law of trusts, contract and tort,¹³⁴ and may apply to a greater or lesser extent to all participants in the investment chain. For example, it is well established that a person who contracts with another to provide a service must provide that service with reasonable care and skill.¹³⁵ Duties of care may also arise in the absence of a contract between the parties, for example where there has been an “assumption of responsibility”.¹³⁶
- 3.69 We refer readers to the discussion of contractual and tortious duties of care in our Consultation Paper.¹³⁷ Here we discuss trustees’ duties of care.

Trustees’ duties of care

General principles

- 3.70 The law, in England & Wales and in Scotland, has long recognised that trustees owe a duty of care. This duty, although it has its origins in equity in England & Wales, is not a fiduciary duty.¹³⁸ Trustees’ duties of care also sit alongside trustees’ other, more specific, duties in relation to the exercise of a power.
- 3.71 Traditionally, trustees’ duties of care arose under the general law or by virtue of the terms of the trust. The extent of the duty was described in *Speight v Gaunt*:

As a general rule a trustee sufficiently discharges his duty if he takes in managing trust affairs all those precautions which an ordinary prudent man of business would take in managing similar affairs of his own.¹³⁹

¹³⁴ Or delict in Scotland.

¹³⁵ See *Henderson v Merrett Syndicates* [1995] 2 AC 145 at 193; *Jackson & Powell on Professional Liability* (7th ed 2011) para 2-013. Where the supplier is acting in the course of a business, this is now in statutory form for England & Wales: see Supply of Goods and Services Act 1982, s 13. For Scotland see W McBryde, *The Law of Contract in Scotland* (3rd ed 2007) para 9-37.

¹³⁶ See, for example, *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465.

¹³⁷ CP 215 paras 6.33 to 6.44.

¹³⁸ *Bristol and West Building Society v Mothew* [1998] Ch 1 at 17; *Permanent Building Society (in liquidation) v Wheeler* (1994) 14 ACSR 109 at 157; *Lewin on Trusts* (18th ed 2012) para 34-01. For a discussion of Scots law on this topic see L Macgregor, *The Law of Agency in Scotland* (1st edn 2013) paras 4.21-4.22.

¹³⁹ (1883) 9 App Cas 1 at 19, by Lord Blackburn, approving Jessel MR in the Court of Appeal (1882) 22 Ch D 727 at 739-740. See also *Re Whiteley* (1886) 33 Ch D 347 at 355, by Lindley LJ. For Scots law see *Raes v Meek* 1889 16 R (HL) 31.

3.72 There has been a move away from this traditional language of “prudence”. In 2000, trustees’ duties of care were put on statutory footing in England & Wales through the Trustee Act 2000 (the 2000 Act). This implemented, with minor changes, the recommendations of the Law Commission and Scottish Law Commission in our 1999 Report on Trustees’ Powers and Duties.¹⁴⁰ The Act signalled a move towards “reasonableness” as the relevant standard of conduct.

3.73 Section 1 of the 2000 Act applies to the wide range of powers listed in schedule 1, including the power to invest, alongside arrangements with agents, nominees and custodians.¹⁴¹ It states:

(1) Whenever the duty under this subsection applies to a trustee, he must exercise such care and skill as is reasonable in the circumstances, having regard in particular—

(a) to any special knowledge or experience that he has or holds himself out as having, and

(b) if he acts as trustee in the course of a business or profession, to any special knowledge or experience that it is reasonable to expect of a person acting in the course of that kind of business or profession.¹⁴²

(2) In this Act the duty under subsection (1) is called ‘the duty of care’.

¹⁴⁰ Trustees’ Powers and Duties (1999) Law Com No 260; Scot Law Com No 172. In Scotland the Charities and Trustee Investments (Scotland) Act 2005 Part 4 implemented the Report’s recommendations on powers. The Scottish Law Commission has, however, considered the matter of duties further in Breach of Trust (2003) Scottish Law Commission Discussion Paper No 123 Part 3; and in Supplementary and Miscellaneous Issues in the Law of Trusts (2011) Scottish Law Commission Discussion Paper No 148 ch 6. A final Report is anticipated in 2014.

¹⁴¹ The 2000 Act is not expressed to have retroactive effect, so the statutory duty of care applies only to acts or omissions after the 2000 Act came into force on 1 February 2001: The Trustee Act 2000 (Commencement) Order 2001 SI 2001 No 49.

¹⁴² In Scotland it is unclear whether the standard of care required of a professional trustee is higher than that required of a gratuitous trustee. The Scottish Law Commission has suggested that there should be a higher standard of care only for a professional trustee who is remunerated for providing the trust with professional services: Supplementary and Miscellaneous Issues in the Law of Trusts (2011), Scottish Law Commission Discussion Paper No 148 ch 6.

- 3.74 The duty of care under the 2000 Act may be excluded or restricted. In addition, the general law continues to apply to duties and powers not covered by the 2000 Act. The duty of care under the 2000 Act does not apply to many of the functions of pension scheme trustees,¹⁴³ which are instead dealt with by the Pensions Act 1995.¹⁴⁴

Investment

- 3.75 When exercising their powers of investment, trustees must exercise reasonable care and skill in accordance with section 1 of the 2000 Act.¹⁴⁵ The nature of a trustee's duty of care with respect to investment was discussed in *Re Whiteley*, where it was said that when investing:

the duty of a trustee is not to take such care only as a prudent man would take if he had only himself to consider; the duty rather is to 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.¹⁴⁶

Lord Justice Cotton added that trustees must have regard “not only to the interests of those who are entitled to the income, but to the interests of those who will take in future”.¹⁴⁷

- 3.76 Below we discuss a number of elements that have been noted as part of trustees' duty of care.

RISK

- 3.77 When exercising the standard of care of an “ordinary prudent man”, trustees are not required to avoid all risk so that in effect they act as insurers for the trust fund. Instead, as was noted in *Re Godfrey*:

The words in which the rule is expressed must not be strained beyond their meaning. Prudent business men in their dealings incur risk. That may and must happen in almost all human affairs.¹⁴⁸

¹⁴³ Most importantly, the duty of care under section 1 of the 2000 Act does not apply to occupational pension scheme trustees in relation to their powers of investment: Trustee Act 2000, s 36(2). Instead, they are subject to a duty of care under the general law and the provisions of the Pensions Act 1995. Importantly, under the general law the same duty of care ordinarily applies to all trustees irrespective of whether they are lay trustees or professional trustees and irrespective of any special knowledge or experience that they may have: *Lewin on Trusts* (18th ed 2012) para 34-09. Trust corporations may be held to a higher standard: *Bartlett v Barclays Bank Trust Co Ltd* [1980] Ch 515 at 534.

¹⁴⁴ The duties of pension scheme trustees in relation to investment are dealt with in Chapter 4..

¹⁴⁵ This provision does not apply to the trustees of occupational pension schemes: Trustee Act 2000, s 36(2).

¹⁴⁶ *Re Whiteley* (1886) 33 Ch D 347 at 355, by Lindley LJ. This was applied in *Cowan v Scargill* [1985] Ch 270 at 289; *Nestle v National Westminster Bank plc* [1993] 1 WLR 1260 at 1267-1268. Though this describes the duty of care under the general law, it is also likely to apply to the statutory duty of care: see *Lewin on Trusts* (18th ed 2012) para 35-64.

¹⁴⁷ *Re Whiteley* (1886) 33 Ch D 347 at 350. See paras 3.57 to 3.61 above.

Similarly, in the more recent case of *Bartlett v Barclays Trust Co* the court held that “the distinction is between a prudent degree of risk on the one hand, and hazard on the other”.¹⁴⁹

- 3.78 The courts have recognised that the concept of risk must adapt to current economic conditions and contemporary understanding of markets and investment. Those subject to duties of care are now required to manage risk by diversification and by considering the suitability of investments.¹⁵⁰ Accordingly, modern trustees acting within their investment powers:

are entitled to be judged by the standards of current portfolio theory, which emphasises the risk level of the entire portfolio rather than the risk attaching to each investment taken in isolation.¹⁵¹

- 3.79 Assets which may individually be hazardous may be offset by safer investments to form a balanced portfolio. The theory is that:

The risk of a portfolio is wholly distinct from the risk of a particular investment contained in the portfolio. The risk of a portfolio is a function of the interrelation of its component investments. Thus, a trustee can use securities and instruments that are highly risky viewed in isolation to assemble a portfolio that is safe.¹⁵²

- 3.80 In *Harries v Church Commissioners*¹⁵³ the court held that the amount of diversification required was a question of degree. It may be acceptable to exclude a few companies, as it was:

Not easy to think of an instance where in practice the exclusion ... of one or more companies or sectors from the whole range of investments open to trustees would be likely to leave them without an adequately wide range of investments from which to choose a properly diversified portfolio.¹⁵⁴

¹⁴⁸ *Re Godfrey* (1883) 23 Ch D 483 at 493, by Bacon VC.

¹⁴⁹ *Bartlett v Barclays Trust Co (No 1)* [1980] Ch 515 at 531, by Brightman J.

¹⁵⁰ *Nestle v National Westminster Bank plc* [1993] 1 WLR 1260 at 1282. See also the standard investment criteria in section 4 of the Trustee Act 2000.

¹⁵¹ *Nestle v National Westminster Bank plc* (1996) 10(4) Trust Law International 112 at 115, by Hoffmann J.

¹⁵² J Gordon, “The Puzzling Persistence of the Constrained Prudent Man Rule” (1987) 62 *New York University Law Review* 52 at 67.

¹⁵³ [1992] 1 WLR 1241.

¹⁵⁴ Above, at 1246, by Nicholls VC.

On the other hand, larger exclusions may make the portfolio less balanced and diversified.¹⁵⁵ It is important to note that diversification guards against firm-specific risk, rather than systemic risk. At times of economic stress, shares tend to fall together, leading to losses in the whole portfolio.¹⁵⁶

HINDSIGHT

- 3.81 It is tempting to judge trustees' decisions with the benefit of hindsight. However, it is clear that this is the wrong approach – the conduct of trustees is to be judged by reference to the facts and circumstances existing at the time when the trustees had to act, and which were known or ought to have been known by them at the time.¹⁵⁷ As Mr Justice Megarry noted in *Duchess of Argyll v Beuselinck*:

In this world, there are few things that could not have been done better with hindsight. The advantages of hindsight include the benefit of having sufficient indication of which of the many factors present are important and which are unimportant. But hindsight is no touchstone of negligence. The standard of care to be expected of a professional man must be based on events as they occur, in prospect, and not in retrospect.¹⁵⁸

- 3.82 This is especially important when the relevant decision was taken many years ago, and when accepted practice differed from what is currently accepted. In *Nestle v National Westminster Bank*, Mr Justice Hoffmann warned that:

In reviewing the conduct of trustees over a period of more than 60 years, one must be careful not to endow the prudent trustee with prophetic vision or expect him to have ignored the received wisdom of his time.¹⁵⁹

¹⁵⁵ [1992] 1 WLR 1241 at 1251.

¹⁵⁶ For further discussion, see R Thornton, "Ethical Investment: a case of disjointed thinking" (2008) 67(2) *Cambridge Law Journal* 396 at 399-401; and E Ford, "Trustee Investment and Modern Portfolio Theory" (1996) 10(4) *Trust Law International* 102 at 102.

¹⁵⁷ *Re Hurst* (1892) 67 LT 96 at 99, by Lindley LJ.

¹⁵⁸ [1972] 2 Lloyd's Rep 172 at 185.

¹⁵⁹ (1996) 10(4) *Trust Law International* 112 at 115.

ADVICE

- 3.83 Trustees' duties of care will often require them to take advice.¹⁶⁰ In *Cowan v Scargill*, Mr Justice Megarry said:

That duty [of care] includes the duty to seek advice on matters which the trustee does not understand, such as the making of investments, and on receiving that advice to act with the same degree of prudence. ... Although a trustee who takes advice on investments is not bound to accept and act on that advice, he is not entitled to reject it merely because he sincerely disagrees with it, unless in addition to being sincere he is acting as an ordinary prudent man would act.¹⁶¹

- 3.84 By way of example, in the Court of Appeal's decision in *Pitt v Holt*, Lord Justice Lloyd said "where tax matters are relevant (as they often will be), it is likely to be the duty of the trustees, under their duty of skill and care, to take proper advice as to those matters."¹⁶²

STEWARDSHIP

- 3.85 In certain circumstances, trustees may be under duties which resemble what is referred to as "stewardship".¹⁶³ This is most likely to be the case where a trust's shareholding confers complete or a substantial measure of control over a company.¹⁶⁴ A leading textbook notes that:

In such circumstances, it is not enough for the trustees to leave the running of the company wholly to the directors. They are under a duty to keep themselves informed about the company's affairs and about the directors' plans for the future.¹⁶⁵

The conclusion reached by the learned editors is that where all or a substantial part of the trust property is represented by a controlling holding in a limited company, the trustees are bound to see that the company's assets are administered cautiously.¹⁶⁶

¹⁶⁰ *Martin v City of Edinburgh District Council* [1989] Pens LR 9 at [32], 1988 SLT 329 at 335.

¹⁶¹ [1985] Ch 270 at 289.

¹⁶² *Pitt v Holt* [2011] EWCA Civ 197 at [119].

¹⁶³ It is not entirely clear whether the duty discussed in this section is part of trustees' duty of care or whether it is a separate duty to intervene in the affairs of a company. The discussion of *Speight v Gaunt* (1883) 9 App Cas 1 and "prudence" in the cases suggests that the former approach is correct: see *Bartlett v Barclays Bank Trust Co Ltd* [1980] Ch 515 at 531-532; *Re Lucking's Will Trusts* [1968] 1 WLR 866 at 874.

¹⁶⁴ *Lewin on Trusts* (18th ed 2012) para 34-49.

¹⁶⁵ Above, citing *Re Lucking's Will Trusts* [1968] 1 WLR 866; *Re Miller's Deed Trusts* [1978] LS Gaz 454; *Bartlett v Barclays Bank Trust Co Ltd* [1980] Ch 515; *Bogg v Raper* (1998-99) 1 ITELR 267; *Walker v Stones* [2001] QB 902 at 916-917; *Younger v Saner* [2002] EWCA Civ 1077 at [66].

¹⁶⁶ *Lewin on Trusts* (18th ed 2012) para 34-50.

- 3.86 An example of this is the case of *Bartlett v Barclays Bank Trust Co Ltd*,¹⁶⁷ where the trustee (a bank) had a 99.8% shareholding in a company which made a disastrous property speculation, leading to the company losing half a million pounds and a loss to the trust fund. The trustees had placed confidence in the company's board and had not sought information beyond that given at annual general meetings. Nor had they interfered with the running of the company.¹⁶⁸ The beneficiaries brought a claim against the trustee for all loss accruing by reason of it having permitted the property company to engage in property development.
- 3.87 The court held that the bank, as trustee, was bound to act in relation to the shares and to the controlling position which they conferred, in the same manner as a prudent man of business. The prudent man of business, the court said, will act in such a manner as is necessary to safeguard his investment.¹⁶⁹ If facts come to their attention which put them on inquiry, they should take appropriate action. The court found that the bank was liable to make good the loss to the trust, and noted:

Appropriate action will no doubt consist in the first instance of inquiry of and consultation with the directors, and in the last but most unlikely resort, the convening of a general meeting to replace one or more directors. What the prudent man of business will *not* do is to content himself with the receipt of such information on the affairs of the company as a shareholder ordinarily receives at annual general meetings.¹⁷⁰

¹⁶⁷ [1980] Ch 515.

¹⁶⁸ Above, at 529.

¹⁶⁹ *Bartlett v Barclays Bank Trust Co Ltd* [1980] Ch 515 at 532. The court also found that a trust corporation, which carries on a specialised business of trust management, owes a higher duty of care than a lay trustee: [1980] Ch 515 at 534. However, the trustee bank was held to be in breach of both the "ordinary" duty of care and the "higher" duty of care: [1980] Ch 515 at 535.

¹⁷⁰ [1980] Ch 515 at 532 (emphasis in original).

- 3.88 However, the appropriate action will depend on the individual circumstances of the case. The court noted that:

Alternatives which spring to mind are the receipt of copies of the agenda and minutes of board meetings if regularly held, the receipt of monthly management accounts in the case of a trading concern, or quarterly reports. Every case will depend on its own facts. The possibilities are endless. It would be useless, indeed misleading, to seek to lay down a general rule. The purpose to be achieved is not that of monitoring every move of the directors, but of making it reasonably probable, so far as circumstances permit, that the trustee or ... one of them will receive an adequate flow of information in time to enable the trustees to make use of their controlling interest should this be necessary for the protection of their trust asset, namely, the shareholding. The obtaining of information is not an end in itself, but merely a means of enabling the trustees to safeguard the interests of their beneficiaries.¹⁷¹

CONCLUSION

- 3.89 The law imposes a variety of controls on participants in the investment chain. It controls the manner in which trustees and other donees exercise their powers: they must not exceed the scope of the power, and they must not exercise a power for an improper purpose. Where they owe fiduciary duties, participants in the investment chain must avoid conflicts and not make unauthorised profits by virtue of their fiduciary position.
- 3.90 The law may also require participants to exercise reasonable care and skill. In England & Wales, professional trustees, or those that hold themselves out as having special skills or experience, may be held to a higher standard.¹⁷² Other participants may owe a duty of care in tort¹⁷³ or in contract.

¹⁷¹ [1980] Ch 515 at 533-534.

¹⁷² For the position in Scotland, see para 3.73, footnote 142, above.

¹⁷³ Or delict in Scotland.

CHAPTER 4

INVESTMENT DUTIES OF PENSION TRUSTEES

- 4.1 Pension scheme trustees invest contributions made by members and employers to generate a return. Thus a central role of pension trustees is to oversee investment strategy.
- 4.2 In this Chapter we outline the legal framework that governs the investment decisions of pension trustees. Our aim in this Chapter is simply to set out the main legal principles, rather than apply them to practical issues. This Chapter acts as a necessary precursor to the next three chapters, which consider the factors which pension trustees should take into account.
- 4.3 This chapter is in three parts.
- (1) We start with a summary of the pensions legislation which governs trustees' investment powers.
 - (2) We then set out the broad principles of trust law. It is often said that pension trustees should act "in the best interests of their beneficiaries". There are only a handful of cases which interpret what this means and we discuss each in turn. The leading case is *Cowan v Scargill*,¹ though useful guidance is also found in some other cases, notably *Martin v City of Edinburgh District Council*² and *Harries v Church Commissioners*.³ We also summarise an analysis of these cases by the Manitoba Law Reform Commission.
 - (3) Thirdly, we consider the main funded statutory scheme, the Local Government Pension Scheme (LGPS). This is not technically a trust, though at a practical level the duties of those managing the scheme's assets will be similar. We provide a brief introduction to the regulations governing the LGPS in England & Wales, and discuss how far the case law on best interests applies to the scheme.
- 4.4 In the previous Chapter, we explained that to answer practical questions about legal duties in financial markets, it is often necessary to draw on multiple sources of law. This is particularly true when considering the investment duties of pension trustees. To understand their legal duties, pension trustees should start with the trust deed: in particular, does it contain any express limitations on their powers? They should then look to the pensions legislation, outlined below. Finally, they should consider the various "judge-made" duties: particularly the duties connected to the exercise of a power, duties of care and fiduciary duties. We outlined these duties in general terms in the previous Chapter, Here we consider how the courts have applied these duties in a pensions context.

¹ [1985] Ch 270.

² [1989] Pens LR 9, 1988 SLT 329.

³ [1992] 1 WLR 1241.

- 4.5 In the next three chapters we focus on the parts of our terms of reference which ask us to consider what financial and non-financial factors trustees may or must consider when making investment decisions. In Chapter 5 we summarise what we said in the consultation paper and discuss the responses we received. In Chapter 6 we set out our final conclusion on the current law and in Chapter 7 we ask if there is a need for reform.

THE PENSIONS LEGISLATION

- 4.6 The investment decisions of pension trustees are governed by the Pensions Act 1995, the Pensions Act 2004 and the various regulations made under these Acts. Here we summarise the most significant provisions: a more detailed analysis can be found in our Consultation Paper.⁴

The investment power

- 4.7 Section 34 of the Pensions Act 1995 provides occupational pension scheme trustees with a wide investment power. They have the same power to make an investment of any kind as if they were absolutely entitled to the assets of the scheme.
- 4.8 However, this power is heavily constrained. It is subject to the provisions of the trust deed, as well as relevant case law. Importantly, this power is also constrained by the Occupational Pension Schemes (Investment) Regulations 2005 (the Investment Regulations).⁵ Regulation 4 requires that:
- (1) investment of the scheme assets is in the best interests of members and beneficiaries;⁶
 - (2) the power of investment is exercised in a manner “calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole”;⁷
 - (3) assets held to cover the scheme’s technical provisions are invested in a manner “appropriate to the nature and duration of the expected future retirement benefits payable under the scheme”;⁸
 - (4) scheme assets consist predominantly of investments admitted to trading on regulated markets.⁹ Other investments must be kept at a prudent level;¹⁰

⁴ CP 215, Chapter 7.

⁵ SI 2005 No 3378.

⁶ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 4(2).

⁷ Above, reg 4(3).

⁸ Above, reg 4(4). A scheme's “technical provisions” means the amount required, on an actuarial calculation, to make provision for the scheme’s liabilities: Pensions Act 2004, s 222(2).

⁹ Above, reg 4(5).

¹⁰ Above, reg 4(6).

- (5) scheme assets must be properly diversified to “avoid excessive reliance on any particular asset, issuer or group of undertakings and so as to avoid accumulations of risk in the portfolio as a whole”,¹¹ and
- (6) investment in derivative instruments may only be made in so far as they contribute to a reduction of risks or facilitate efficient portfolio management.¹²

4.9 Regulation 4 of the Investment Regulations implements article 18(1) of the Institutions for Occupational Retirement Provision (IORP) Directive.¹³ At the time, the Government took the view that many of the requirements imposed by article 18(1) might already be in place as a result of the common law duty to invest prudently and other statutory requirements. In the event, the Government acted on legal advice that compliance with directives should be demonstrable in regulation.

4.10 Schemes with fewer than 100 members are excluded from the requirements of regulation 4 of the Investment Regulations,¹⁴ even though small schemes are common.¹⁵ Under the Regulations, trustees of schemes with fewer than 100 members have a more limited duty to have regard to the diversification of investments in so far as appropriate to the circumstances of the scheme.¹⁶ However, we think that many of the elements of regulation 4 already effectively apply to such schemes as a result of general trust law.

4.11 If the regulations are breached, the Pensions Regulator (TPR) may take action, including applying civil penalties under the Act.¹⁷

Delegation

4.12 Section 34(2) of the Pensions Act 1995 provides that any decision about investments may be delegated by or on behalf of the trustees to an investment manager authorised (or exempt from authorisation) by the Financial Conduct Authority (FCA). Under section 47(2) of the Pensions Act 1995, where an occupational pension scheme has assets including investments, an investment manager¹⁸ *must* be appointed.

¹¹ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 4(7).

¹² Above, reg 4(8). Derivative instruments are defined as including any of the instruments listed in paragraphs (4) to (10) of Section C of Annex 1 to the Markets in Financial Instruments Directive 2004/39/EC, Official Journal L145 of 30.4.2004 p 1.

¹³ The Investment Regulations implement the requirements of the Institutions for Occupational Retirement Provision (IORP) Directive 2003/41/EC, Official Journal L 235 of 23.09.2003 p 10.

¹⁴ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 7.

¹⁵ For example, Spence Johnson reports that, out of 45,295 defined contribution trust-based schemes, 43,804 (97%) had fewer than 100 members: Spence Johnson, *Defined Contribution Market Intelligence* (2013) p 16.

¹⁶ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 7(2).

¹⁷ See Pensions Act 1995, ss 10 and 36(8)(a).

¹⁸ The Pensions Act 1995 uses the language of “fund manager”, but the terminology of “investment manager” has been adopted in this report.

- 4.13 Trustees will often delegate their discretion to make decisions about investments to an investment manager because managing investments belonging to another by way of business, in circumstances involving the exercise of discretion, is a regulated activity requiring FCA authorisation.¹⁹ Whilst some occupational pension scheme trustees are authorised, the vast majority are not.
- 4.14 Occupational pension scheme trustees are taken to be managing scheme assets “by way of business”, even if they are unpaid individuals.²⁰ The key exception is where trustees delegate decision making to an investment manager. Where the investment manager carries out all the “day-to-day” decisions relating to the management of securities or contractually-based investments and is authorised by the FCA, the trustees will fall within this exception.²¹ Therefore, to avoid the need for authorisation, occupational pension scheme trustees must ensure that all such decisions are delegated under the Pensions Act 1995.
- 4.15 There is no definition of what constitutes a “day-to-day” decision. FCA guidance is that such decisions will include:
- (1) decisions to buy, sell or hold particular securities or contractually based investments such as an investment manager would be expected to make in their everyday management of a client's portfolio; and
 - (2) recommendations made to investment managers, on a regular basis, with a force amounting to direction relating to individual securities or contractually based investments.²²
- 4.16 The effect of these rules is that occupational pension scheme trustees will usually be restricted to making “strategic” decisions only. This will include decisions:
- (1) about the adoption or revision of the statement of investment principles;
 - (2) about the formulation of a general asset allocation policy;
 - (3) affecting the balance between income and growth; or
 - (4) about the appointment of investment managers.²³

¹⁹ Financial Services and Markets Act 2000, s 22 and sch 2, para 6; Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 SI 2001 No 544, art 37. However, it is only a regulated activity if, generally, the assets being managed consist of or include any investment which is a security or a contractually based investment.

²⁰ Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order SI 2001 No 1177, art 4(1).

²¹ Above, art 4(1)(b).

²² FCA Handbook PERG 10.3, Q9.

²³ Above, Q8.

Trustees may also make “day-to-day” decisions about investments in pooled investment products (provided they have taken and considered advice),²⁴ and in certain exceptional circumstances (for example, takeover situations or where there are sensitive policy considerations).²⁵

No exclusion of the duty of care

- 4.17 As we noted in Chapter 3,²⁶ pension trustees are under a duty to exercise reasonable care and skill when exercising their powers of investment. Under section 33(1) of the Pensions Act 1995, pension trustees cannot exclude or restrict any liability for breach of an obligation under any rule of law to take care or exercise skill in the performance of investment functions. This marks a stark contrast to other forms of trustee, who may exclude their duties of care.²⁷
- 4.18 However, if the trustees delegate their investment discretion to an investment manager in accordance with section 34(2) of the Pensions Act 1995, the trustees will not be responsible for the acts or defaults of the investment manager, provided the trustees have taken all reasonable steps to satisfy themselves that the investment manager is suitable,²⁸ is carrying out the work competently and is complying with the Investment Regulations.²⁹
- 4.19 Meanwhile the investment manager to whom investment discretion is delegated in this way becomes subject to duties under the pensions legislation. In particular:
- (1) Investment managers must exercise their discretion in accordance with the Investment Regulations.³⁰ This includes the requirement in regulation 4(2) that the investment of scheme assets is in the best interests of the beneficiaries.

²⁴ Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order SI 2001 No 1177, arts 4(1)(b), 4(6). Pooled investment products include units in collective investment schemes, shares issued by an investment company and contracts of insurance.

²⁵ FCA Handbook PERG 10.3, Q8. Occupational pension scheme trustees may also make decisions of any kind about investing in assets that are not securities or contractually based investments, such as real property, cash or precious metals.

²⁶ See para 3.77 and following above.

²⁷ In Scotland, liability for gross negligence cannot be excluded: see *Spread Trustee Co v Hutcheson* [2011] UKPC 13 at [48]; *Lutea Trustees Ltd v Orbis Trustees Guernsey Ltd* 1997 SC 255. The law is discussed, but no reform suggested, in *Breach of Trust* (2003) Scottish Law Commission Discussion Paper No 123 paras 3.12-3.61. The Discussion Paper did suggest (at para 3.46) that professional trustees should be unable to exclude liability for breach of their duties of care and skill. See also D Cabrelli, “Scotland”, in D Busch and D DeMott (eds), *Liability of Asset Managers* (1st ed 2012) paras 15.27-15.30.

²⁸ Section 34(4) of the Pensions Act 1995 requires trustees to take all reasonable steps to satisfy themselves that an investment manager has the appropriate knowledge and experience for managing the investments of the scheme.

²⁹ Pensions Act 1995, ss 34(4), 34(6). These sections require trustees to take all reasonable steps to satisfy themselves that an investment manager is complying with section 36 of the Pensions Act 1995. Section 36 requires trustees (and any investment manager to whom discretion is delegated) to exercise their powers of investment, among other things, in accordance with regulations.

³⁰ Above, s 36(1).

- (2) Investment managers are prohibited from excluding or limiting their liability to take care or exercise skill in the performance of any investment functions.³¹ This is in contrast to investment managers in other circumstances, who may limit liability.

Statement of investment principles (SIP)

4.20 A statement of investment principles is “a written statement of the investment principles governing decisions about investments for the purposes of the scheme”.³² Under section 35(1), trustees “must secure” that a SIP is “prepared and maintained”, and that it is reviewed and “if necessary, revised”. Under section 36(5), the trustees, or the investment manager to whom any discretion has been delegated, must exercise their powers of investment in accordance with the SIP “so far as reasonably practicable”.

4.21 The Investment Regulations provide further detail about the content of a SIP. Under regulation 2(3), the SIP must include a statement of the trustees’ policy on:

- (1) securing compliance with the rules on choosing investments in the pensions legislation;³³
- (2) the kinds of investments to be held;
- (3) the balance between different kinds of investments;
- (4) risk;
- (5) the expected return on investments;
- (6) the realisation of investments;
- (7) the extent to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments; and
- (8) the exercise of the rights (including voting rights) attaching to investments.

4.22 The fact that trustees are required to state their policy on the extent to which social, environmental or ethical considerations are taken into account when investing does not necessarily mean it is permissible for them to do so. A pensions text suggests that the investment strategy set out in the SIP:

Must accord with the general law ... and be devised to reflect the liability position of the scheme in question.³⁴

³¹ Pensions Act 1995, s 33(1)(b).

³² Pensions Act 1995, s 35(2).

³³ Regulation 2(3)(a) of the Investment Regulations requires that a SIP must state the trustees’ policy for securing compliance with section 36 of the Pensions Act 1995. In particular, section 36(1) requires trustees (and any investment manager to whom discretion has been delegated) to exercise their powers of investment in accordance with regulations. This will include regulation 4 of the Investment Regulations.

- 4.23 The obligation to review the SIP is clarified by regulation 2(1) of the Investment Regulations,³⁵ which provides that the SIP must be reviewed “at least every three years” and “without delay after any significant change in investment policy”. Failure to do so exposes the trustees to civil penalties.³⁶
- 4.24 Before preparing or revising a SIP, pension trustees must obtain and consider “proper advice”, discussed below. They should also consult with the scheme’s sponsoring employer.³⁷ Pension trustees may be required to disclose details of any investments that were not made in accordance with the statement of investment principles, giving the reasons why and explaining what action, if any, they propose to take (or have taken) to remedy the position.³⁸

Proper advice

- 4.25 Under section 36(3), the trustees must obtain and consider “proper advice” as to whether an investment is satisfactory, taking into account the criteria in regulation 4 of the Investment Regulations and the principles contained in the SIP. For existing investments, trustees should obtain advice periodically, when it is “desirable”.³⁹
- 4.26 Section 36(6) states that “proper advice” means advice from someone authorised under FSMA, or the advice:

of a person who is reasonably believed by the trustees to be qualified by his ability in and practical experience of financial matters and to have the appropriate knowledge and experience of the management of the investments of trust schemes.

Under section 36(7), trustees will not be taken to have fulfilled their duty to obtain and consider “proper advice” unless the advice was given or confirmed in writing. Failure to comply with the advice requirements exposes trustees to civil penalties.⁴⁰

³⁴ Nabarro Pensions Team, *Pensions Law Handbook* (11th ed 2013) para 10.26.

³⁵ SI 2005 No 3378.

³⁶ Pensions Act 1995, s 35(6).

³⁷ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 2(2)(b).

³⁸ See the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 SI 2013 No 2734.

³⁹ Pensions Act 1995, s 36(4).

⁴⁰ Pensions Act 1995, s 36(8).

Defined contribution (DC) default funds

4.27 There is more specific guidance about investment strategies for defined contribution default funds. Default funds have always been an important element of DC schemes, and will become even more important following auto-enrolment. All auto-enrolment schemes must include a default fund.⁴¹ The Department for Work and Pensions (DWP) has published detailed guidance on their design, noting that:

The default option should take account of the likely characteristics and needs of the employees who will be automatically enrolled into it. It is likely that employees in the default fund will not be engaged in financial decisions. Decisions will need to be taken for them about their risk profile. As such there should be an appropriate balance between risk and return for the likely membership profile and the charging structure should reflect this balance.⁴²

4.28 Typically, default funds provide “lifestyle profiles”. Each member is allocated units, and the funds in which these units are invested change as the member nears their retirement date. As retirement approaches, the investments move away from what are typically considered “growth” assets, such as equities, and into what are usually considered more secure assets, such as bonds. An alternative approach is that adopted by providers such as NEST, which at any one time offers a series of retirement date funds. By default, all members retiring in, for example, 2055 are enrolled into the NEST 2055 Retirement Date Fund. The asset allocation of the fund is adjusted as the retirement date approaches.

4.29 The guidance also recommends that the design, performance and continued suitability of the default option should undergo a full review at least every three years.⁴³

4.30 As we discuss in Chapter 9,⁴⁴ the Government has announced that it plans to introduce regulations to strengthen trustees’ duties in relation to default funds. The new regulations will specify that default investment strategies must be designed in the interests of members, with a clear statement of aims, objective and structure. In addition, the characteristics and net performance of default investment strategies must be regularly reviewed to ensure alignment with the interests of members.⁴⁵

THE PRINCIPLES OF TRUST LAW

4.31 Pension trusts are also governed by the general principles of trust law, as set out in case law. In particular, trustees are subject to the three types of duties discussed in Chapter 3, specifically duties connected to the exercise of a power, duties of care and fiduciary duties.

⁴¹ Pensions Act 2008, s 17(2)(b).

⁴² Department for Work and Pensions, *Guidance for offering a default option for defined contribution automatic enrolment pension schemes* (May 2011) para 15.

⁴³ Above, para 23.

⁴⁴ See para 9.30 below.

⁴⁵ Better workplace pensions: Further measures for savers (2014) Cm 8840 p 12.

- 4.32 There is, however, a growing recognition that pension trusts are “different”, and that they may merit separate consideration. Whereas private trusts usually contain an element of gift and are typically used as vehicles to manage wealth efficiently, the members of pension schemes are not volunteers but instead have paid for their interests under the trust through their contributions. As Sir Nicolas Browne-Wilkinson VC noted in *Imperial Group Pension Trust v Imperial Tobacco*, this may affect how the courts treat such trusts:

The traditional trust is one under which the settlor, by way of bounty, transfers property to trustees to be administered for the beneficiaries as the objects of his bounty. ... The beneficiaries have given no consideration for what they receive. ... A pension scheme is quite different. Pension benefits are part of the consideration which an employee receives in return for the rendering of his services. ... Beneficiaries of the scheme, the members, far from being volunteers have given valuable consideration. The company employer is not conferring a bounty. In my judgment, the scheme is established against the background of such employment and falls to be interpreted against that background.⁴⁶

- 4.33 In the later case of *Target Holdings Ltd v Redferns*, Lord Browne-Wilkinson added:

It is in any event wrong to lift wholesale the detailed rules developed in the context of traditional trusts and then seek to apply them to trusts of quite a different kind. In the modern world the trust has become a valuable device in commercial and financial dealings. The fundamental principles of equity apply as much to such trusts as they do to the traditional trusts in relation to which those principles were originally formulated. But in my judgment it is important, if the trust is not to be rendered commercially useless, to distinguish between the basic principles of trust law and those specialist rules developed in relation to traditional trusts which are applicable only to such trusts and the rationale of which has no application to trusts of quite a different kind.⁴⁷

- 4.34 One author has noted that the fact that pension scheme members are not passive objects of a bounty “must influence the attitude of the courts towards the obligations of trustees”.⁴⁸ It is therefore important to interpret trust law flexibly: there is an element of judgement in deciding how far a non-pensions case is relevant to a pensions context.

⁴⁶ [1991] 1 WLR 589 at 597.

⁴⁷ [1996] AC 421 at 435.

⁴⁸ D Pollard, *The Law of Pension Trusts* (1st ed 2013) para 2.13.

The meaning of “best interests”

- 4.35 It is often said that trustees must act “in the best interests of members and beneficiaries”. This phrase appears in the case law, in the Investment Regulations,⁴⁹ and in the IORP Directive.⁵⁰ However, it has no statutory definition. Its meaning is discussed in a small number of cases, of which the most significant is *Cowan v Scargill*.⁵¹ As we discuss below, this is a particularly difficult case which has generated considerable controversy. We also outline the few other cases which interpret its meaning.

Cowan v Scargill

The case

- 4.36 *Cowan v Scargill* was a dispute between the trustees of a mineworkers’ pension scheme. Five trustees appointed by the National Union of Mineworkers (NUM) refused to approve an investment plan unless it was amended to prohibit investments in overseas companies or in oil and gas. The other trustees claimed that this was a breach of fiduciary duty. The leading NUM trustee, Arthur Scargill, argued the case in person. He said that such investments were against union policy, would damage the coal industry and would be against beneficiaries’ interests.⁵² He argued that he could maintain this objection, even if it was to the fund’s financial detriment.⁵³
- 4.37 The court held that the NUM trustees were in breach of their duties. Their duty was to put the interests of their beneficiaries first, and normally this meant their best financial interests.⁵⁴ The court recognised there may be circumstances in which financially disadvantageous arrangements may be in the beneficiaries’ best interests, but the burden of proving this would rest very heavily on the trustees.⁵⁵ Further, trustees should not be influenced by their personal views and may even have to act dishonourably (although not illegally) to obtain the best result for their beneficiaries.⁵⁶
- 4.38 On the facts, the court found that the proposed exclusion of certain investments was not in the beneficiaries’ best interests. In particular, the interests of retirees, and the widows and children of deceased miners, differed from the interests of the union and the industry as a whole. The connection between the coal mining industry and the beneficiaries was “too remote and insubstantial”,⁵⁷ so the trustees should not have based their investment decisions on the effect on the industry.

⁴⁹ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 4(2).

⁵⁰ Institutions for Occupational Retirement Provision (IORP) Directive 2003/41/EC, Official Journal L 235 of 23.09.2003 p 10, art 18(1)(a).

⁵¹ [1985] Ch 270.

⁵² Above, at 282.

⁵³ Above, at 284-285.

⁵⁴ Above, at 287.

⁵⁵ Above, at 288.

⁵⁶ Above, at 287-288. See paras 4.53 to 4.56 below.

⁵⁷ [1985] Ch 270 at 292.

4.39 Sir Robert Megarry VC stated the applicable law:

The starting point is the duty of trustees to exercise their powers in the best interests of the present and future beneficiaries of the trust, holding the scales impartially between different classes of beneficiaries. This duty of the trustees towards their beneficiaries is paramount. They must, of course, obey the law; but subject to that, they must put the interests of their beneficiaries first. 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. In the case of a power of investment, as in the present case, the power must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risks 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.⁵⁸

4.40 Arthur Scargill had argued that trustees could not be criticised for excluding some investments for social or political reasons. The judge did not accept this assertion “in its full width”. He continued:

If the investment in fact made is equally beneficial to the beneficiaries, then criticism would be difficult to sustain in practice, whatever the position in theory. But if the investment in fact made is less beneficial, then both in theory and in practice the trustees would normally be open to criticism.⁵⁹

⁵⁸ [1985] Ch 270 at 286-287.

⁵⁹ Above, at 287.

- 4.41 However, the judge noted that there may be an exception to this general rule. He said:

I am not asserting that the benefit of the beneficiaries which a trustee must make his paramount concern inevitably and solely means their financial benefit, even if the only object of the trust is to provide financial benefits. Thus if the only actual or potential beneficiaries of a trust are all adults with very strict views on moral and social matters, condemning all forms of alcohol, tobacco and popular entertainment, as well as armaments, I can well understand that it might not be for the "benefit" of such beneficiaries to know that they are obtaining rather larger financial returns under the trust by reason of investments in those activities than they would have received if the trustees had invested the trust funds in other investments. The beneficiaries might well consider that it was far better to receive less than to receive more money from what they consider to be evil and tainted sources. "Benefit" is a word with a very wide meaning, and there are circumstances in which arrangements which work to the financial disadvantage of a beneficiary may yet be for his benefit But I would emphasise that such cases are likely to be very rare⁶⁰

The debate

- 4.42 *Cowan v Scargill* has sparked great debate.⁶¹ It has been taken to support the view that the maximisation of value and yield should drive investment decisions.⁶² There has been discussion over whether the statement in *Cowan* that "the best interests of the beneficiaries are normally their best financial interests"⁶³ could be seen as precluding pension schemes from taking into account environmental, social and governance issues when making investment decisions.⁶⁴

⁶⁰ [1985] Ch 270 at 288.

⁶¹ See, for example, P Watchman, J Anstee-Wedderburn and L Shipway, "Fiduciary duties in the 21st century: a UK perspective" (2005) 19(3) *Trust Law International* 127 at 127 where it was stated that the view that profit maximisation is the fundamental fiduciary duty is "based on a fundamental misunderstanding of the law" and should not be followed. See also S Hulme, "The basic duty of trustees of superannuation trusts - fair to one, fair to all?" (2000) 14(3) *Trust Law International* 130 and X Frostick, "Is there a duty to act in the best interests of the beneficiaries?" (2000) 83(Feb) *Pension Lawyer* 2.

⁶² R Thornton, "Ethical Investment: a case of disjointed thinking" (2008) 67(2) *Cambridge Law Journal* 396 at 398.

⁶³ [1985] Ch 270 at 287.

⁶⁴ C Scanlan, *Socially Responsible Investment: A Guide for Pension Schemes and Charities* (1st ed 2005) p 79.. P Watchman, J Anstee-Wedderburn and L Shipway, "Fiduciary duties in the 21st century: a UK perspective" (2005) 19(3) *Trust Law International* 127 at 127-128; Freshfields Bruckhaus Deringer, *A legal framework for the integration of environmental, social and governance issues into institutional investment* (2005) p 89; FairPensions (later known as ShareAction), *Protecting our best interests: rediscovering fiduciary obligation* (2011) p 19-20.

- 4.43 In 2005, Freshfields Bruckhaus Deringer published a report commissioned by the Asset Management Working Group of the United Nations Environment Programme Finance Initiative (UNEP FI).⁶⁵ The UNEP FI had asked Freshfields to investigate whether the integration of ESG issues into investment policy is “voluntarily permitted, legally required or hampered by law and regulation”, and to identify any common misconceptions against such integration.⁶⁶
- 4.44 The Freshfields Report concluded that *Cowan v Scargill* was “not a reliable legal authority”.⁶⁷ Scargill “represented himself”, so the case was “not properly argued” and it should be “limited to its particular facts”.⁶⁸ Freshfields quote a lecture given by Sir Robert Megarry VC after he decided *Cowan v Scargill*, in which he described it as “a dull case” that should not be taken as saying profit must be maximised at all costs.⁶⁹ The report comments that, read carefully, the case merely confirms that fiduciary powers must be exercised “carefully and fairly for the purposes for which they are given and not so as to accomplish any ulterior purpose”.⁷⁰
- 4.45 This was also the view of Lord Nicholls. Commenting extra-judicially, he thought that the duty to act in the beneficiaries’ best interests was a formulation in different words of a trustee’s duty to promote the purpose for which the trust was created.⁷¹ In the Consultation Paper we commented that this was a helpful interpretation.

Other relevant cases

Martin v City of Edinburgh District Council

- 4.46 In the Scottish case of *Martin v City of Edinburgh District Council*,⁷² a group of councillors challenged the decision of Edinburgh District Council to disinvest its trust funds from South Africa at the time of the apartheid regime. This followed the Council’s policy to be “an apartheid-free authority” in all its dealings.

⁶⁵ The UNEP FI is a global partnership between the United Nations Environment Programme and the financial sector.

⁶⁶ Freshfields Bruckhaus Deringer, *A legal framework for the integration of environmental, social and governance issues into institutional investment* (2005) p 6.

⁶⁷ Above, p 89.

⁶⁸ Above, p 89.

⁶⁹ Above, p 9.

⁷⁰ Above, p 89.

⁷¹ Lord Nicholls, “Trustees and their Broader Community: Where Duty, Morality and Ethics Converge” (1996) 70 *Australian Law Journal* 205 at 211.

⁷² [1989] Pens LR 9, 1988 SLT 329.

4.47 The Court of Session found that the Council had failed in its duty as trustee. This was not because the decision to disinvest in South Africa was necessarily wrong, but because the Council had made the decision in the wrong way. The Council had applied a pre-existing policy: it did not consider whether it was in the best interests of the beneficiaries or seek professional advice on the issue.⁷³ Lord Murray held that “trustees have a duty not to fetter their investment discretion for reasons extraneous to the trust purpose, including reasons of a political or moral nature”.⁷⁴

4.48 Notably, the court explicitly reached this conclusion on “the general principles of law applicable to trusts in Scotland” and not on *Cowan*, should this differ.⁷⁵ However, in a non-binding comment as to the meaning of *Cowan*, Lord Murray stated that:

I accept that the most profitable investment of funds is one of a number of matters which trustees have a duty to consider. But I cannot conceive that trustees have an unqualified duty ... simply to invest trust funds in the most profitable investment available. To accept that without qualification would, in my view, involve substituting the discretion of financial advisers for the discretion of trustees.⁷⁶

4.49 Lord Murray recognised that it may not be possible for a trustee to “divest himself of all personal preferences, of all political beliefs, and of all moral, religious or other conscientiously held principles”.⁷⁷ Nevertheless, they must do their “best to exercise fair and impartial judgment” in the interests of the beneficiaries.⁷⁸ Trustees should genuinely apply their minds to the merits of a particular trust decision and, if they are not able to exercise fair and impartial judgment, must abstain from participating in deciding the issue.

Harries v Church Commissioners

4.50 In *Harries v Church Commissioners*⁷⁹ the Bishop of Oxford and other members of the clergy challenged the investment policy of the Church Commissioners who managed the substantial trust funds of the Church of England. They claimed the commissioners attached undue importance to financial considerations in making investment decisions and failed to take into account the underlying purpose for which the assets were held – the promotion of the Christian faith.

⁷³ [1989] Pens LR 9 at [24], [32], 1988 SLT 329 at 331-2, 334.

⁷⁴ [1989] Pens LR 9 at [33], 1988 SLT 329 at 334.

⁷⁵ [1989] Pens LR 9 at [32], 1988 SLT 329 at 333, by Lord Murray.

⁷⁶ [1989] Pens LR 9 at [33], 1988 SLT 329 at 334.

⁷⁷ Above.

⁷⁸ Above.

⁷⁹ [1992] 1 WLR 1241.

- 4.51 The court held that although the commissioners were in law a charity, the purpose of the trustees' investment powers was to make money: "most charities need money and the more of it there is available, the more the trustees can seek to accomplish".⁸⁰ Charitable trustees could restrict investments which conflicted with the work of a charity; for example, a cancer charity could refuse to invest in tobacco. They could also exclude investments which would alienate their supporters. But trustees should not lose sight of the purpose of their investment powers.⁸¹ They should not make financially detrimental investment decisions based on moral concerns where there were differing views among their supporters.
- 4.52 On the facts, the commissioners operated an "ethical" policy, which excluded around 13% of listed UK companies (by value), including alcohol, tobacco and armaments firms. The judge, Sir Donald Nicholls VC, found that the trustees did not err in law by adopting this ethical policy. On the other hand, the claimants' proposed plan would have excluded around 37% of listed UK companies. The judge commented:

Not surprisingly, the commissioners' view is that a portfolio thus restricted would be much less balanced and diversified, and they would not regard it as prudent or in the interest of those for whom they provide.⁸²

The judge held that, given the "endless argument and debate" over what Christian ethics require, the commissioners were "right not to prefer one view over the other beyond the point at which they would incur a risk of significant financial detriment".⁸³

Buttle v Saunders: a duty to gazump?

- 4.53 It is sometimes said that fiduciary duties are concerned with maintaining "the highest standards of probity".⁸⁴ The American judge Chief Justice Cardozo classically stated that:

A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.⁸⁵

⁸⁰ [1992] 1 WLR 1241 at 1246.

⁸¹ Above, at 1247.

⁸² Above, at 1251.

⁸³ Above, at 1251.

⁸⁴ D Hayton, *The Law of Trusts* (4th ed 2003) p 37; see also J Langbein, "The Contractarian Basis of the Law of Trusts" (1995-1996) 105 *Yale Law Journal* 625 at 658.

⁸⁵ *Meinhard v Salmon* (1928) 164 NE 545 (NY) at 546.

4.54 However, the case of *Buttle v Saunders*⁸⁶ is a reminder that the duty is to act in the interests of the beneficiaries – not to act morally in a general sense. Trustees under a will had entered into negotiations for the sale of trust property. Draft contracts had been prepared but not concluded. At this stage, the trustees received a higher offer but refused it on the basis that they felt honour-bound not to withdraw from the initial negotiations. The beneficiaries challenged this decision. The court held that there may be legitimate circumstances in which trustees could refuse a higher offer, such as the certainty of the original offer. However, on the facts the trustees had only considered the honour of withdrawing from existing negotiations. This was incorrect.

4.55 The case has proved controversial. In response to our Consultation Paper, the Church of England National Investing Bodies argued that “it would be unhelpful to give the impression that high standards of behaviour in business and investment are irrelevant”. James Featherby argued that the case may have been correct on its facts but has little relevance to modern pension funds. The case concerned a small private trust which did not engage in regular commercial dealings. By contrast:

The best financial interests of many pension funds would be damaged if the trustees of those funds, or the funds themselves, were to gain a reputation for acting legally but dishonourably.

4.56 It would, for example, endanger positive relationships with suppliers and materially increase the cost of doing business with counterparties. *Buttle v Saunders* may be confined to its facts and it is uncertain how it would be applied today. Of course, trustees should not act if it would lead to long-term detriment to the fund.

The Manitoba Law Reform Commission’s report

4.57 In January 1993, the Manitoba Law Reform Commission published a report on ethical investment by trustees, which reviewed the cases of *Cowan* and *Harries* alongside similar cases from the USA.⁸⁷ The report reached the following conclusions:

- (1) Where the purpose of a trust is the provision of financial benefits to the beneficiaries, absent any express direction from the person creating the trust as to the non-financial criteria to which the trustee may properly have regard when exercising his investment discretion, the securing of a reasonable financial return should be the trustees’ predominant concern.
- (2) However, there may be circumstances where it would be appropriate to include ethical or other non-financial factors as additional (but subordinate) factors. This will particularly be the case where the trust can reasonably be said to encompass objectives which go beyond the predominant goal of securing a reasonable financial return. Moreover:

⁸⁶ [1950] 2 All ER 193.

⁸⁷ Manitoba Law Reform Commission, *Ethical Investment by Trustees* (January 1993).

- (a) An investment policy which respected the reasonable and firmly held moral precepts of a trust's beneficiaries may be justified, provided it does not imperil the financial returns to the trust.
 - (b) It may be appropriate to have regard to widely held societal values. A trustee who chooses not to invest the trust's assets in enterprises notorious for dangerous products or discriminatory hiring practices should not be guilty of breach of trust, provided the trustees have nonetheless ensured a sufficiently wide range of alternative investments to produce a reasonable financial return.
- (3) Trustees should not be permitted to be guided by their own personal views as to what is ethical or what is an appropriate non-financial criterion. They must be guided by what can objectively be considered appropriate non-financial criteria. Nor should they have unlimited discretion to consider non-financial criteria; such criteria remain subordinate to the primary objective of producing a reasonable financial return.
- (4) However, a trustee of a trust for financial benefits who keeps paramount the need to provide a safe and reasonable financial return on investments, but who honestly and reasonably considers non-financial criteria in the formulation of investment policy should not be penalised. The law should make clear that the consideration of non-financial criteria is not imprudent as such, so long as it does not displace the primary obligation to maximise the financial benefit to the trust.

4.58 The Manitoba Law Reform Commission suggested an amendment to the Manitoba Trustee Act to implement these recommendations and to "dispel the suggestion that the use of non-financial criteria in investment policy is necessarily proscribed". They noted that:

The balance to be achieved should be the creation of a defined scope for the proper consideration of non-financial criteria, on the one hand, with the fundamental need to protect the financial integrity of a trust for financial benefits, on the other hand.⁸⁸

The amendment suggested by the Manitoba Law Reform Commission has been made.⁸⁹

⁸⁸ Manitoba Law Reform Commission, *Ethical Investment by Trustees* (January 1993) p 43.

⁸⁹ The Trustee Act (Manitoba), s 79.1.

STATUTORY SCHEMES

Introduction

- 4.59 In Chapter 2, we noted that many public service pension schemes are set up under statute, rather than a trust. The largest of these is the Local Government Pension Scheme (LGPS), and this is the only one of the main public service pension schemes that holds and invests assets.⁹⁰
- 4.60 The LGPS is established under sections 7 and 12 of the Superannuation Act 1972. Following the introduction of a new scheme on 1 April 2014, the LGPS in England and Wales is governed primarily by the Local Government Pension Scheme Regulations 2013 (the LGPS Regulations).⁹¹ However, the investment of LGPS funds continues to be subject to the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 (the LGPS Investment Regulations).⁹²
- 4.61 The LGPS Regulations require each of the listed “administering authorities” to maintain a pension fund and to manage and administer the scheme.⁹³ There are 89 regional LGPS funds in England and Wales, with a further 11 in Scotland and 1 in Northern Ireland. The LGPS in Scotland has been devolved to Scottish Ministers and is the responsibility of the Scottish Public Pensions Agency.⁹⁴

Management and investment of funds

- 4.62 Scheme funds must be managed and invested in accordance with the LGPS Investment Regulations. In many respects, the Regulations impose requirements similar to those imposed by the Occupational Pension Scheme Regulations 2005 on private sector occupational schemes.

Investment policy

- 4.63 Under the LGPS Investment Regulations, administering authorities must formulate a policy for the investment of their fund money, with a view to:
- (1) the advisability of investing fund money in a wide variety of investments;
- and

⁹⁰ Although it is not the only funded public service pension scheme. The Parliamentary Contributory Pension Fund (PCPF) also operates on a funded basis. The PCPF is governed by a board of trustees, who have delegated the day to day responsibility for the management and operation of the fund to the House of Commons Department of Finance.

⁹¹ SI 2013 No 2356.

⁹² SI 2009 No 3093.

⁹³ See Part 1 of Schedule 3 to the Regulations. All of the administering authorities are local authorities, save for the London Pension Funds Authority, the South Yorkshire Pension Authority, and the Environment Agency.

⁹⁴ The Secretary of State's functions under section 7 of the Superannuation Act 1972 in so far as they were exercisable in relation to Scotland were devolved to Scottish Ministers by section 63 of the Scotland Act 1998 and article 2 of, and Schedule 1 to, the Scotland Act 1998 (Transfer of Functions to Scottish Ministers etc.) Order 1999 SI 1999 No 1750.

(2) the suitability of particular investments and types of investments.⁹⁵

4.64 An administering authority is also required, after consultation with such persons as it considers appropriate, to prepare, maintain and publish a SIP.⁹⁶

Delegation

4.65 The LGPS Investment Regulations allow the administering authority, instead of managing and investing fund money itself, to appoint one or more investment managers to do so on its behalf.⁹⁷ However, the administering authority must take proper advice in relation to the appointment.⁹⁸

4.66 The LGPS Investment Regulations prohibit long-term appointments. For example, the administering authority must be able to terminate the appointment by not more than one month's notice.⁹⁹ They also require that the investment manager must report to the administering authority at least once every three months,¹⁰⁰ and that the authority keeps the investment manager's performance under review.¹⁰¹

4.67 Professor Kay criticised this practice of short-term appointments coupled with quarterly reviews. Typically, investors assess their manager against a benchmark, and Professor Kay thought that this it encouraged "closet indexation" – that is, actively managed portfolios which nevertheless mimic closely the composition of an index:

Only by following a benchmark closely can a fund manager expect to avoid lengthy periods of underperformance if such performance is measured on a monthly or quarterly basis.¹⁰²

4.68 He thought that "noise in information – the frequent reporting of data irrelevant to long-term value creation – should be reduced".¹⁰³ He therefore recommended that mandatory quarterly reporting obligations should be removed.¹⁰⁴

⁹⁵ Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 SI 2009 No 3093, reg 11.

⁹⁶ Above, reg 12.

⁹⁷ This is subject to the various conditions set out in Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 SI 2009 No 3093, reg 8(2). For example, the authority must reasonably believe that the investment manager's ability in and practical experience of financial matters makes that investment manager suitably qualified to make investment decisions for it.

⁹⁸ Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 SI 2009 No 3093, reg 8(6).

⁹⁹ Above, reg 9(2).

¹⁰⁰ Above, reg 9(3).

¹⁰¹ Above, reg 10.

¹⁰² J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012) para 5.22.

¹⁰³ Above, p 70.

¹⁰⁴ Above, Recommendation 11.

“Best interests”

4.69 In contrast to the duties on private sector occupational pension schemes, there is no specific requirement in the LGPS Investment Regulations to invest scheme assets in the best interests of scheme members.

4.70 As we noted above,¹⁰⁵ article 18(1) of the IORP Directive imposes a “best interests” duty. Member States must require that “institutions for occupational retirement provision” in their territories invest in accordance with the “prudent person” rule. In particular, the following rule must be complied with:

The assets shall be invested in the best interests of members and beneficiaries. In the case of a potential conflict of interest, the institution, or the entity which manages its portfolio, shall ensure that the investment is made in the sole interest of members and beneficiaries.¹⁰⁶

4.71 This provision has only been transposed into UK law for private sector occupational pension schemes.¹⁰⁷ During consultation with stakeholders prior to the publication of our consultation paper, UNISON sent us an opinion written by Michael Furness QC on the potential application of the IORP Directive to the LGPS.¹⁰⁸ Mr Furness QC was of the view that the Directive, and article 18 in particular, applied to the LGPS. In 2008, the Government said that it shared this view.¹⁰⁹ Nevertheless, as Mr Furness QC noted in his opinion, on the face of domestic legislation:

There is nothing to stop the administering authority from taking decisions on investments which prefer its interests and the interests of the other employers over the interests of the members of the LGPS.

¹⁰⁵ See para 4.9 above.

¹⁰⁶ Institutions for Occupational Retirement Provision (IORP) Directive 2003/41/EC, Official Journal L 235 of 23.09.2003 p 10, art 18(1)(a).

¹⁰⁷ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 4.

¹⁰⁸ This opinion is now available at <http://www.lgpsboard.org/images/PDF/IEJanuary2014/QCMF>.

¹⁰⁹ Letter from Peter Hain, Secretary of State for Work and Pensions to the General Secretary of UNISON (18 January 2008).

4.72 It is unclear what effect this failure to transpose has on the duties of administering authorities in practice. Several authorities appear to regard themselves as “quasi-trustees”,¹¹⁰ and as a consequence bound by the decisions in cases such as *Cowan v Scargill*. Moreover, there is a strong argument that that article 18(1) has direct effect in UK law. The Court of Justice of the European Union (CJEU) has held that an individual may derive rights from provisions of an unimplemented or incorrectly implemented directive where they are “unconditional and sufficiently precise”.¹¹¹ We think these requirements may be satisfied here. The time period for transposition has also, as required for direct effect, expired.¹¹²

4.73 However, an individual may only invoke directly effective provisions of a directive against the member state.¹¹³ We think that LGPS administering authorities will meet this test. This is because the CJEU has given “member state” a broad interpretation. In *Foster* the CJEU said that it included:

organisations or bodies which were subject to the authority or control of the State or had special powers beyond those which result from the normal rules applicable to relations between individuals.¹¹⁴

4.74 This has been held to include local and regional authorities,¹¹⁵ and any bodies, whatever their legal form, which have been made responsible, pursuant to a measure adopted by the state, for providing a public service under the control of the state and have for that purpose special powers beyond those which result from the normal rules applicable in relations between individuals.¹¹⁶ There is a strong argument that administering authorities satisfy this test.

Investment in tobacco

4.75 A consequence of the lack of a clear “best interests” duty on administering authorities has been uncertainty over the extent to which authorities can rely on non-financial factors when making investment decisions. The issue has arisen most recently in light of the transfer of public health duties to local government, and the consequent pressure to disinvest from tobacco.

¹¹⁰ See, for example, Lincolnshire County Council (<http://www.lincolnshire.gov.uk/upload/public/attachments/519/LCCSIP.pdf>) and the London Borough of Lewisham (<http://councilmeetings.lewisham.gov.uk/Data/Pensions%20Investment%20Committee/20061106/Agenda/6e0ff781ad14484b89a7d938d71886bftem3EthicalInvesting6November2006.PDF>).

¹¹¹ Case 8/81 *Becker* [1982] ECR 53 at [25].

¹¹² Case 148/78 *Ratti* [1979] ECR 1629 at [43]-[44]. The time period for transposition of the IORP Directive expired on 23 September 2005.

¹¹³ Above, at [22].

¹¹⁴ Case C-188/89 *Foster and Others* [1990] ECR I-3313 at [18].

¹¹⁵ Case 103/88 *Fratelli Constanzo* [1989] ECR 1839 at [31]-[32].

¹¹⁶ Case C-188/89 *Foster and Others* [1990] ECR I-3313 at [20].

- 4.76 At its meeting on 14 October 2013, the LGPS Advisory Board decided that a report produced jointly by Norfolk County Council and Hymans Robertson LLP on the issue “forms a useful position for funds until such time as further clarification on this matter is available”.¹¹⁷ That report took the view that excluding stocks relating to tobacco would reduce the potential diversification of remaining investments and increase the underlying volatility of return. It also noted that only one LGPS fund (the London Borough of Newham) has been identified as excluding tobacco from its investments, albeit not for ethical reasons but because “tobacco companies may face large liabilities from outstanding court actions”.¹¹⁸
- 4.77 The LGPS Advisory Board has since taken advice from Nigel Giffin QC on what considerations may legitimately influence the exercise of investment discretion by administering authorities. The opinion of Mr Giffin QC was that administering authorities were subject to fiduciary duties, and that administering authorities should exercise their investment powers in a manner directed towards what is best for the financial position of the fund. However, he also noted that the precise choice of investments may be influenced by wider social, ethical or environmental considerations, so long as that does not risk material financial detriment to the fund. In taking account of any such considerations, however, the administering authority should not seek to impose its particular views where those would not be widely shared by scheme employers and members (nor may other scheme employers impose their views upon the administering authority).
- 4.78 The opinion reached by Mr Giffin QC on the integration of non-financial considerations into the exercise of the investment discretion is consistent with the view we take with respect to pension trustees. Such factors may be taken into account, apart from in certain exceptional cases, only where this would not result in significant financial detriment to the fund.

Comment on the LGPS Investment Regulations in England and Wales

- 4.79 We think two aspects of the LGPS Regulations could usefully be reviewed. First, in practice administering authorities consider themselves to be quasi-trustees, acting in the best interests of their members. We think that the same rules which apply to pension fund trustees in taking account of wider or non-financial factors will also be taken to apply to LGPS administering authorities. There is an argument that the IORP Directive requires this. However, we think that uncertainty on this point is undesirable and that the matter should be put beyond doubt. It would be helpful if the LGPS Investment Regulations made it clear that administering authorities must act in the best interests of pension scheme members.
- 4.80 Secondly, it may be timely to review the practice of short-term appointments coupled with quarterly reviews, in the light of the criticisms made by Professor Kay. We do not think that it is appropriate to make any recommendations about the LGPS in Scotland as this is a devolved matter. However, the appropriate Scottish authorities may wish to consider this issue in light of our recommendations.

¹¹⁷ See <http://www.lgpsboard.org/index.php/publications>. The LGPS Advisory Board is a body established under section 7 of the Public Service Pensions Act 2013.

¹¹⁸ See <http://www.lgpsboard.org/images/PDF/IEOctober2013/Norfolk> at para 8.2.

- 4.81 We return to this issue in Chapter 7,¹¹⁹ where we make formal recommendations for the review of both the Occupational Pension Scheme (Investment) Regulations 2005 and the Local Government Pension Scheme Regulations 2013.

CONCLUSION

- 4.82 Pension trustees are subject to a variety of legal duties when making investment decisions. In particular, they must invest the scheme assets in the best interests of scheme members and beneficiaries. The phrase “best interests” is undefined in the Investment Regulations and remains the subject of debate. The case of *Cowan v Scargill* is often cited in support of the view that beneficiaries’ interests will typically be their best financial interests, and that maximisation of value and yield should drive investment decisions. However, many believe that this case would not be interpreted in this way today.
- 4.83 LGPS administering authorities are not subject to the same duties. Administering authorities manage funds on the basis of specific statutory powers and duties, rather than the pensions legislation and general trust law. These differences have led to uncertainty about which investment factors authorities may take into account when investing. It is likely that rules similar to those that apply to trust-based schemes will also apply to the LGPS.

¹¹⁹ See paras 7.86 to 7.88 below.

CHAPTER 5

FACTORS IN PENSION TRUST INVESTMENT: CONSULTATION PAPER AND RESPONSES

5.1 The Kay Review reported concerns that:

Some pension fund trustees equated their fiduciary responsibilities with a narrow interpretation of the interests of their beneficiaries which focused on maximising financial returns over a short timescale and prevented the consideration of longer term factors which might impact on company performance, including questions of sustainability or environmental and social impact.¹

5.2 Other submissions to the Review, however, commented that pension fund trustees who insisted on a narrow view of fiduciary duty were often hiding behind risk-averse legal advice. The Law Commission was asked to address any uncertainties or misunderstandings on this issue.

5.3 Our terms of reference ask us to evaluate the extent to which fiduciaries may or must consider:

- (a) factors relevant to long-term investment performance which might not have an immediate financial impact, including questions of sustainability or environmental and social impact;
- (b) interests beyond the maximisation of financial return;
- (c) generally prevailing ethical standards, and / or the ethical views of their beneficiaries, even where this may not be in the immediate financial interest of those beneficiaries;

5.4 In this chapter we begin by summarising our preliminary views, as expressed in the Consultation Paper. We then highlight the areas in which consultees expressed concern. We take each issue in turn, reporting in more detail on consultees' views, before offering some conclusions. These initial conclusions are then applied in Chapter 6, which is a standalone chapter containing our final view of the law on the factors which pension trustees may or must consider when making investments.

¹ J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012) para 9.20.

WHAT WE SAID IN THE CONSULTATION PAPER

5.5 We addressed this issue in Chapter 10 of the Consultation Paper, summarising the law as follows:

- (1) The core duty of a trustee is to promote the purpose for which the trust was created. A trustee should start with the trust deed: what is the purpose of the power I have been given, and how can I use the power to promote that purpose? In the case of a pension scheme, the simple answer is that the purpose is to provide pensions.
- (2) Trustees must act within the confines of the legislation. For example, the Occupational Pension Scheme (Investment) Regulations 2005 require an investment power to be exercised in a manner “calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole”.² They also require the portfolio to be properly diversified to “avoid excessive reliance on any particular asset, issuer or group of undertakings”.³
- (3) Within these broad parameters, trustees must exercise their own discretion. The courts will not second guess the decision itself. Instead, the law requires that trustees go through the right procedure to reach their decision, keeping the purpose at the front of their minds.
- (4) In reaching their decision, trustees are subject to various procedural duties. They must not fetter their discretion; they should consider relevant circumstances; and they should take advice.
- (5) Overlying the above, trustees should act “with such care and skill as is reasonable in the circumstances”. This must be judged at the time the decision was made, not with hindsight.

5.6 Stakeholders raised a variety of factors which trustees may wish to take into account when making investment decisions. These were: environmental, social and governance factors relevant to financial returns; “macroeconomic” factors; non-financial factors, such as “quality of life” and “purely ethical” concerns; and the views of beneficiaries. Stakeholders also raised concerns over the scope and extent of stewardship activities. We offered the following preliminary views about each of these factors.

Environmental, social and governance factors

5.7 Conventional investment decision-making has always been guided by subjective opinion, such as assessments of a firm’s markets and the competition it faces. Many investors now look at a broader range of issues, often referred to as “environmental, social and governance” (ESG) factors.

² Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 4(3).

³ Above, reg 4(7).

- 5.8 At its most basic, taking account of ESG factors is designed to reduce risks. The Kay Review highlights how poor safety procedures, together with a lack of environmental concern, may lead to disastrous and expensive mistakes.⁴ However, an ESG driven approach is not simply about avoiding the next company crisis. It works on the basis that companies do better in the long-term if they are well-run and sustainable, and have loyal suppliers, customers and employees. The Consultation Paper referred to many studies which found a link between ESG factors and company performance.
- 5.9 We were told that there were still some uncertainties over how far pension trustees could take ESG considerations into account. ShareAction thought that this is “partly down to the persistence of myths and misconceptions about fiduciary duty”.⁵ We said that we hoped to remove finally the misconception that trustees cannot take into account ESG considerations.
- 5.10 Wider factors relevant to long-term investment performance may be taken into account where they would further the purpose of the trust. Given the evidence that companies that are well governed and follow sustainable policies can produce better returns in the long run, the answer is clearly that pension trustees *may* consider such factors when making investment decisions.
- 5.11 We thought that trustees should consider, in general terms, whether their policy will be to take account of ESG factors in their decision-making, bearing in mind the resources available to them. However, we thought that the law allowed trustees discretion not to do so if, after due consideration, they thought that another strategy would better serve the interests of their beneficiaries.

Wider systemic considerations

- 5.12 It was argued that since many pension funds hold such diverse portfolios, they are essentially interested in the performance of the economic as a whole. We said that it is permissible to take into account macroeconomic factors where this is justified by the benefits to the portfolio as a whole. For example, trustees may accept a lesser return on one investment if this is justified by benefits to other investments in the portfolio. The anticipated benefits of an investment decision based on such factors must, however, outweigh the likely costs. Again, trustees should consider, in general terms, whether to take account of such factors, but remain free to use a different approach if they believe it would better serve their beneficiaries.

Non-financial factors

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

⁴ For example, the Deepwater Horizon saga significantly reduced the value of BP shares: see J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012) para 1.22.

⁵ ShareAction, Response to “Fiduciary Duties of Investment Intermediaries: Initial Questions” (July 2013).

- 5.14 We then considered how far trustees may take account of “purely ethical” concerns, designed to show moral disapproval of activities, rather than avoid long-term risks. We said that purely ethical issues, unrelated to risks or returns, may only be taken into account in limited circumstances. Clearly, trustees should not invest in activities which are illegal. Nor did we think that trustees should invest in activities which contravene international conventions. Outside these narrow areas, however, ethical issues are highly contested.
- 5.15 We said that trustees of general pension funds should only disinvest for purely ethical reasons (unrelated to financial risk) if two conditions are satisfied. Firstly, the trustees must have good reason to think that scheme members would share their outlook. Secondly, they should anticipate that the decision will not result in financial detriment to the scheme.
- 5.16 We outlined two further exceptions to this rule:
- (1) Where a pension fund is set up by a religious group, charity or political organisation, trustees are not required to make investments which conflict with the aims of the organisation.
 - (2) In defined contribution (DC) schemes, members may be offered an ethical pension as a choice.

Beneficiaries’ views

- 5.17 We said that trustees may consider the views of their beneficiaries when making investment decisions, but there is no need for them to do so. Trustees must make the ultimate decision.

Stewardship

- 5.18 Within the context of pension fund investment, we also addressed the issues surrounding stewardship over invested funds. We noted that investment decisions are not simply concerned with decisions to buy or sell shares and other investments. As shareholders, trustees may also guide their investee companies by entering into dialogue with them and considering whether and how to exercise voting rights.
- 5.19 We did not think that pension trustees had an enforceable legal obligation to engage in the stewardship of companies. However, for large funds, stewardship was one possible tool. Where a company is in danger of making poor long-term decisions it may be more effective to engage with the company to influence the decision, rather than simply sell the shares. We commented that such direct engagement is expensive and may be beyond the resources of most trustees.

CONSULTEES' VIEWS

Is this a correct statement of the law?

- 5.20 We asked consultees whether our conclusions were a correct statement of the law. A large majority agreed that they were.

The wide-ranging and in-depth review of fiduciary responsibilities fairly represents the current legal obligations and responsibilities of trustees in trust based pension schemes. [Local Authority Pension Fund Forum]

Yes we agree and welcome the quality and clarity within the summary of the current legal situation. [United Nations Principles for Responsible Investment Initiative]

- 5.21 Consultees thought that our interpretation of the law was permissive enough to allow trustees sufficient judgement and discretion.

The interpretation of the law as set out within the consultation document rightly suggests that the law as currently understood is sufficiently permissive to enable trustees to use their judgement and discretion appropriately. [National Association of Pension Funds]

The Law Commission rightly suggests that the law, as currently understood, is sufficiently permissive to enable trustees to utilise judgement and discretion appropriately. [Association of British Insurers]

Concerns

- 5.22 Only two consultees completely disagreed with our interpretation of the law.⁶ However, the issue generated considerable debate with many comments, often on the tone rather than the substance of what we said. Five particular concerns have led us to reconsider the expression and details of our conclusions, if not the underlying substance.

- (1) We were asked for more detail about “the purpose of a pension fund”. In particular, consultees thought we should give more guidance about how the trustees of defined benefit schemes should weigh the interests of the employer against the interests of beneficiaries, and whether different considerations applied to defined contribution schemes.
- (2) Several consultees asked us to make it clear that trustees are not required to maximise returns, at the expense of risk factors.
- (3) Consultees asked us to be clearer in our terminology, particularly in our use of terms such as “ethics” and ESG factors.
- (4) Some consultees argued that if ESG factors were financially relevant, their use should not be optional: instead trustees should be obliged to consider them.

⁶ Network for Sustainable Financial Markets and James Featherby.

- (5) Many consultees took issue with the view that “engagement is expensive and may be beyond the resources of most trustees”. It was said that even small schemes were able to delegate stewardship to investment managers.
- 5.23 In the rest of this chapter we examine each of these concerns in more detail and revisit the Consultation Paper’s preliminary views. Our final conclusions on factors in pension trust investment are then set out in the next chapter.

WHAT IS THE PURPOSE OF THE TRUST?

- 5.24 The core duty of a trustee is to promote the purpose for which the trust was created. We said that a trustee should ask: “what is the purpose of the power I have been given?” In the case of a pension scheme, “the simple answer” is that the purpose is to provide pensions.
- 5.25 Most consultees agreed with this analysis:

The primary duty of pension scheme trustees is to ensure that the benefits promised under the pension scheme can be paid. [Sacker & Partners LLP]

In taking decisions in relation to investment matters, trustees are obliged to fulfil the purposes for which they exist. In the case of pension trustees that is the provision of pensions. [Turcan Connell]

Our view is that the primary purpose of pension fund trustees’ investment powers should be to ensure that contributions are invested to provide the promised pensions in the future, and that other purposes are valid but should be subsidiary to this principle. [Association of Consulting Actuaries]

- 5.26 However, others commented that the purpose of a pension trust may be more complex than we had suggested.

The purpose of investment powers in different types of pension

- 5.27 We still think that, in broad terms, the purpose of a pension trust is to provide a pension. However, we accept that there are subtleties and nuances to this question which require further elaboration. For instance, in a DB scheme, there are questions about trustees’ duties to the employer. As Macfarlanes put it, “trustees of defined benefit pension schemes have a duty to the sponsoring employers as well as the members”. So, factors influencing investment decisions may differ between DB and DC pensions, and (within DC pensions) between default and chosen funds. Below we look at each in turn.

DB funds

- 5.28 The essential attribute of a DB scheme is that the members' benefits are guaranteed by the employer. This means that any failure by the trustees to obtain the necessary rate of return will result in the employer having to increase their contributions into the scheme. As David Fox put it:

So long as the employer was still a going concern, it would be the primary underwriter for the pension benefits promised to the members.⁷

- 5.29 Clearly, in economic terms, the employer has an interest in the performance of the scheme. However, it is less clear how far the law obliges trustees to take into account the interests of the employer. In many cases, the employer will be an express beneficiary under the terms of the trust. The trust instrument may, for example, include provisions allowing for the payment of a surplus to the employer, even where the scheme is ongoing.⁸ However, in the absence of express provision, employers are not beneficiaries under the scheme: and there is some debate in England & Wales over whether they may be considered a "quasi-beneficiary".

- 5.30 In their response to our consultation, Freshfields Bruckhaus Deringer LLP explained that:

[The employer's] obligations (e.g. to fund the scheme, whether under the terms of the scheme or statute) are lower if the trustees properly comply with their duties (e.g. to achieve a greater investment return). This reduction of a payment obligation to the trust should (in our view) result in the same beneficiary status as a positive payment obligation out of the trust.⁹

- 5.31 MacFarlanes LLP made a similar argument in favour of a duty towards the sponsoring employer, arguing that:

This is not merely because the sponsoring employer is a residual beneficiary of the trust. Rather, it is an acknowledgment of the impact of the open ended balance of cost responsibility on the employer's business and cash flow.

⁷ D Fox, *Defined Benefit Pension Trusts: Asset Partitioning and the Residual Interest* (November 2010) Paper No 10/03, p 20.

⁸ Such payments are regulated by section 37 of the Pensions Act 1995.

⁹ The employer is also a residual beneficiary in that a surplus on the winding up of the scheme may be held on resulting trust for them: *Davis v Richards & Wallington Industries Ltd* [1990] 1 WLR 1511 at 1538-1545.

5.32 The courts have considered this issue in relation to the treatment of surpluses. In *Edge v Pensions Ombudsman*,¹⁰ the trustees sought to reduce their scheme surplus, which would otherwise have attracted adverse taxation, by reducing the contributions made by employers and employee members in service and increasing pension benefits to members in service. However, there were no increases in benefits for pensioners, who complained to the Ombudsman. The High Court and the Court of Appeal both found for the trustees. It noted that the trustees' duty was no more than the ordinary duty to exercise their discretion for its proper purpose, giving due consideration to relevant matters and excluding the irrelevant; that, provided they did so, they could not be criticised if they appeared to prefer the claims of one interest over others.

5.33 Lord Justice Chadwick noted that any decision to increase benefits will usually require the trustees to consider (amongst other matters) the circumstances in which the surplus has arisen. Where the source of the surplus was past overfunding by the employer, it may be fair and equitable to provide the employer with a contributions holiday. He added that trustees:

must ... always have in mind the main purpose of the scheme—to provide retirement and other benefits for employees of the participating employers. They must consider the effect that any course which they are minded to take will have on the financial ability of the employers to make the contributions which that course will entail. They must be careful not to impose burdens which imperil the continuity and proper development of the employers' business or the employment of the members who work in that business. The main purpose of the scheme is not served by putting an employer out of business.¹¹

5.34 Thus pension trustees should use their powers to secure a return which will provide the agreed benefits to members without imposing burdens on the employer which might imperil the continuity and proper development of the employers' business.

5.35 If the employer's guarantee fails, the Pension Protection Fund (PPF) provides some protection. However, as discussed in Chapter 2,¹² the PPF does not provide full protection. Members who have not yet reached normal pension age will receive only 90% of entitlement, and higher earners are subject to a cap. This is clearly not in the interests of members. At its most basic, trustees should use their powers to try to secure returns which avoid this outcome, as far as is practicable. In practice, as Lord Justice Chadwick noted, the interests of the beneficiaries are protected by the trustees paying appropriate regard to the interests of the scheme's sponsoring employer.

¹⁰ [2000] Ch 602.

¹¹ Above, at 626-627.

¹² See paras 2.39 to 2.40 above.

DC default funds

- 5.36 In DC schemes, the member is more directly affected by the investment strategy, for better or for worse. As we have seen, however, most people find decisions about pensions to be complex, hard, unpleasant and time-consuming.¹³ The majority of members are placed in a default fund, where trustees are asked to devise an appropriate investment strategy. Essentially, trustees are asked to make the decisions that members would have made for themselves, if they had the time, expertise and motivation to do so.
- 5.37 The very nature of the default fund means that members are unlikely to express views on how money is invested. Those who have explicit views are likely to choose specific funds instead. However, trustees may be guided by more general research into members' views. It may also be possible as NEST have done, to research the views of the general population as a proxy for members' views.¹⁴
- 5.38 As a starting point, however, trustees should assume that their members will judge the success of the investment policy by the size of the pension they receive on retirement. However, younger members will judge the investment strategy in the long-term, which requires a long-term approach. Members will have little interest in immediate high returns if the result is an accumulation of risks, leading to a lower pension in forty years' time.
- 5.39 Recent research suggests that charges are the most significant factor influencing the member's level of pension. As the Pensions Institute's report put it:
- While the investment strategy has an important impact on member outcomes, it is much less important than the impact of charges.¹⁵
- 5.40 An analysis of UK equity unit trusts found that very few fund managers outperformed the index consistently, and those that did extracted the whole of this superior performance for themselves in fees, leaving nothing for investors.¹⁶
- 5.41 In the light of this evidence, the Government has concluded that members should not be "defaulted into paying for more expensive investment strategies, where there is little evidence that these consistently benefit members".¹⁷ Therefore from April 2015 a charge cap will apply to all default funds used for DC qualifying schemes. Charges and deductions (excluding transaction costs) may not exceed 0.75% of funds under management.

¹³ The Office of Fair Trading has summarised the evidence on this issue: Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014) paras 5.7-5.10. See also CP 215 paras 13.38 to 13.41..

¹⁴ This was referred to in ShareAction's response to our Consultation Paper.

¹⁵ D Harrison, D Blake and K Dowd, *VfM: assessing value for money in defined contribution default funds* (January 2014) p 13.

¹⁶ Better workplace pensions: Further measures for savers (2014) Cm 8840 p 48.

¹⁷ Above, p 57.

- 5.42 As Professor Kay makes clear, a low-cost investment strategy is compatible with a long-term investment strategy. However, the charge cap will constrain trustees in the strategies they may use. There may be a tension between an approach which takes into account a very wide range of factors and the need to keep costs low.

DC chosen funds

- 5.43 Different considerations apply to chosen funds. In Chapter 4, we noted that pension scheme members are not passive objects of a bounty and are entitled to make their own investment choices. As we explore in Chapter 9, there are some problems in the way that chosen funds are sold and monitored, but as far as ethical investment is concerned the issues are relatively straightforward. Members may decide to sacrifice some income in old age for ethical concerns, provided that decision is fully informed. We commented that it is good practice for trustees to offer ethical or Shariah funds, if members ask for them.

Conclusion

- 5.44 Although in broad terms, the purpose of all pension funds is to provide a pension, trustees' decisions may vary from fund to fund.
- 5.45 In DB schemes, trustees should "be careful not to impose burdens which imperil the continuity and proper development of the employers' business or the employment of the members who work in that business". This is not because trustees owe duties to the employer as such but because the employer's insolvency, leading to the failure of the guarantee, is not in the best interests of scheme members.
- 5.46 In DC default funds, the initial presumption is that trustees should look to provide the best realistic returns over the long-term, while keeping costs low. In DC chosen schemes, however, there is more scope to follow the ethical preferences of the beneficiary, even if this might reduce long-term returns.

MAXIMISING RETURNS AT THE EXPENSE OF LONG-TERM RISKS?

- 5.47 ShareAction put forward a strong argument that the purpose of pension investment was not simply to maximise returns:

We agree with this interpretation of the law, but believe that the law allows for a broader approach to the "purpose of the trust" in a pension fund context. In particular, we would emphasise that the purpose of a pension fund is to provide beneficiaries with a retirement income capable of underpinning a decent standard of living. This is not identical with the maximisation of portfolio returns, and, as the Kay Review observed, an interpretation of the law which equates these two things may not serve beneficiaries' best interests.

- 5.48 More broadly, ShareAction argued that the language of "maximising returns" was unhelpful.

Prevailing interpretations of the law may encourage trustees to neglect certain risk factors which are not well captured by short-term financial data or conventional investment models. The frequent invocation of the mantra “we have a duty to maximise returns” (usually not preceded by the phrase 'risk-adjusted') reflects this bias. This is a sharp contrast from the pre- and early-twentieth century notion of prudence as “safe” investment, embodied by the ‘closed list’ system. While we would not suggest a return to that interpretation, which is undoubtedly outdated, it is possible the pendulum has swung too far the other way.

- 5.49 Several other consultees asked us to confirm that trustees should not be expected to maximise returns without regard to long-term risks. The Intergenerational Foundation argued that “achieving the highest possible returns in the short-term” discriminates against younger beneficiaries:

Under the current laws, trustees are supposed to act impartially towards all their beneficiaries, yet in practice the focus which many trusts place on achieving the highest possible returns in the short-term effectively discriminates in favour of their older beneficiaries, who receive the higher returns in the form of pensions, while possibly endangering the money invested by their younger beneficiaries if such investment strategies involve greater risk.

- 5.50 Royal London Asset Management also argued that short term profit should not jeopardise younger members:

Trustees must balance the long-term needs of future beneficiaries with the more imminent obligation to current pensioners - one should not jeopardise the other. In our view, the Law Commission has not sufficiently addressed the issue of intergenerational equity in the consultation and as a result, a thorough understanding of beneficiaries’ best interests as a whole remains wanting.

- 5.51 Similarly, Legal & General Investment Management commented that:

Beneficiaries’ interests span well into the future, therefore it is critical that asset owners do not place too heavy an emphasis on the interests of today’s retirees at the expense of tomorrow’s. Asset owners, advisors and asset managers should be mandated to look at long term horizons, in order to align the interests of all beneficiaries.

Comment

5.52 We accept the point made by ShareAction and others that trustees are not required to “maximise returns”. Trustees must weigh returns against risks, including long-term risks. It is often said that trustees should “optimise the risk return ratio”. We think this is correct, but it may not be a helpful way of thinking about the problem, as it suggests that the decision is a mathematical one. Only some risks can be reduced to numbers – and the search for numbers may lead investors astray. Typically, an investor is presented with copious data about the past, but, as Professor Kay put it, “past performance is not necessarily a guide to future performance: it is, in fact, virtually no guide to future performance”.¹⁸

5.53 The courts have stressed the importance of reducing risks. In *Re Whiteley*, the court said that the duty is :

to take such care as an ordinary prudent man would make if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide.¹⁹

5.54 The Manitoba Law Reform Commission’s report into ethical investment explained that the duty of prudence requires trustees “to both attain an adequate or reasonable return and preserve the trust capital”.²⁰ In their conclusions they summarised this as follows:

The securing of a reasonable financial return is and should remain the predominant consideration.²¹

5.55 We think that “reasonable” is too low a standard. We would prefer to say that trustees should exercise their investment power to secure the best realistic return over the long-term.

Conclusion

5.56 The primary purpose of the investment power given to pension trustees is to secure the best realistic return over the long-term, given the need to control for risks. We would emphasise that this is a question of broad judgment rather than mathematical formulae – and must be judged at the time of the decision, not in hindsight.

¹⁸ J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012) para 5.21.

¹⁹ *Re Whiteley* (1886) 33 Ch D 347 at 355, by Lindley LJ. This was applied in *Cowan v Scargill* [1985] Ch 270 at 289; *Nestle v National Westminster Bank plc* [1993] 1 WLR 1260 at 1267-1268. Though this describes the duty of care under the general law, it is also likely to apply to the statutory duty of care: see *Lewin on Trusts* (18th ed 2012) para 35-64.

²⁰ Manitoba Law Reform Commission, *Ethical Investment by Trustees* (January 1993) p 32.

²¹ Above, p 42.

THE NEED FOR CLARITY OVER TERMS

- 5.57 Several consultees asked for greater clarity over terms, especially the distinction we drew between ethics and “ESG” factors.²²

We ask the Commission to clarify its use of term “Ethics”... We would ask the Commission to take care with terminology and be clear in its references to avoid confusion. [Strathclyde Pension Fund]

Some of the definitions and suppositions outlined in the consultation document are ambivalent or inconsistent. At times, the consultation document indulges the fallacious assumption that ethical factors are, as a class of information, by definition, non-financial. [Royal London Asset Management]

- 5.58 Several consultees thought that we had not distinguished sufficiently between “individual ethics” and “business ethics”. As Legal & General Investment Management put it:

We are concerned by the Commission’s confusing interpretation of the term “ethics”. Firstly, a distinction needs to be made between individual ethics and the common understanding of ‘business ethics’. We, as asset managers, would not impose our own ethics in managing companies. However, we cannot create a healthy market in which business ethics are ignored or overlooked.

- 5.59 First State Investments made a similar distinction:

Further clarification on what is meant by ethical issues in this context is needed as investee companies’ approach to business ethics and conduct are different to moral and values based debates around involvement in certain types of legitimate (but controversial) business activities (e.g. tobacco or weapons manufacture). Without such clarification trustees’ potential acceptance of unethical and/or unsustainable business practices, so long as a company is making money, undermines market integrity and efficiency by incentivising unethical behaviour and exposes the trustee (and by definition the beneficiaries) to potentially unpredictable financial risks when such behaviour is exposed.

- 5.60 It was said that our discussion of the role of ethics focused too narrowly on the strategy of excluding certain investments, known as “negative screening”. ShareAction argued that ethics were not simply about negatively screening some “sin” stocks such as alcohol and tobacco. Instead, ethics permeated all decision making, including the use of ESG factors and stewardship activity.

²² Four consultees drew attention to a mistake in the glossary, in which the “E” in ESG factors was said to stand for “ethical” rather than “environmental”.

Conclusion

- 5.61 We agree that we need to distinguish clearly between factors which are financially relevant and those which are not. Where a company's approach to ethics leads to unpredictable risks, this is highly relevant to the financial returns, and is therefore a financial factor. This contrasts with non-financial decisions, motivated by other concerns, such as improving members' quality of life or showing disapproval of certain industries.
- 5.62 In Chapter 6 we draw a clearer distinction between financial factors, which are relevant to increasing returns or reducing risks, and non-financial factors, which are motivated by other concerns. In broad terms, trustees may always take into account financially relevant factors. We then explain that trustees may take account of non-financial factors if two tests are satisfied: trustees should have good reason to think that scheme members would share the concern; and it should not involve a risk of significant financial detriment to the fund.

SHOULD TRUSTEES ALWAYS TAKE ESG FACTORS INTO ACCOUNT?

- 5.63 In the Consultation Paper we said that given the evidence that ESG factors can lead to better returns in the long run pension trustees *may* consider ESG factors. However, we thought that the law allowed trustees not to take an ESG approach if, after due consideration, they consider that another strategy would better serve the interests of their beneficiaries.

Trustees may take ESG factors into account

- 5.64 There was substantial agreement with our view that trustees *may* take ESG considerations into account. The following views are typical:

We thus wholly agree with the Law Commission's statement in Paragraph 10.55 "Given the evidence that ESG factors can lead to better returns over the longer-term, the answer is clearly that pension trustees may use wider factors. There can be no objection to using ESG factors as a way of increasing long-term performance." And we also firmly agree with this statement from paragraph 10.66 "we think that trustees should consider, in general terms, whether their policy will be to take account of ESG factors in their decision-making, bearing in mind the resources available to them". [United Nations Principles for Responsible Investment Initiative]

Environmental, social and governance factors can influence financial returns and, to the extent they may do so, it is in beneficiaries' best interests for them to be taken into account. [Capita Employee Benefits and Capita Trust Company Limited]

Research continues to demonstrate that active stewardship and integration of ESG factors within investment decisions can lead to improved risk-adjusted performance. It has certainly not been found to have a detrimental impact on performance. [Association of British Insurers]

Must trustees take ESG into account?

- 5.65 However, some consultees argued that the law requires trustees to take account of all relevant considerations. If ESG factors are financially relevant, it followed that their use was not optional. Instead, trustees must always consider them.

If ESG factors can influence long-term value and if engagement with companies can help to reduce long-term risk and increase value, then trustees have a fiduciary obligation to take ESG factors into account and to expedite engagement with their portfolio companies. [Hermes Equity Ownership Services]

The Commission has stated that the flexibility of the law is such that trustees ‘may’ take ESG concerns into account when making investment decisions. The distinction between ‘may’ and ‘must’ in considering wider factors should be based on financial materiality. As you conclude that there is a link between ESG and company performance, the continued suggestion of ‘may’ is contradictory and misleading. We urge for a clearer explanation of the application of the law in incorporating ESG, in order to empower asset owners to protect and maximise their assets in the short, medium and long term.” [Legal and General Investment Management]

- 5.66 In the Consultation Paper we argued that the courts tended to allow trustees considerable discretion and were not prescriptive of a particular approach to investment. As the court stressed in *Pitt v Holt*:

It is not enough to show that the trustees’ deliberations have fallen short of the highest possible standards, or that the court would, on a surrender of discretion by the trustees, have acted in a different way.²³

- 5.67 ShareAction contrasted the consultation paper’s “very relaxed approach to the duty to take all relevant considerations into account”, compared with “an extremely strict and cautious approach to the duty to exercise investment powers for a proper purpose”:

We agree that this reflects the likely approach that would be taken by the courts (although we think that this is not certain and could be subject to debate). However, we are not convinced that this state of affairs is conducive to the best interests of beneficiaries.

- 5.68 EIRIS endorsed these comments while Eumedion asked the Law Commission to “take a stronger position” on the issue of ESG.

Therefore, we would welcome duties of care that clearly encourage pension trustees to take account of ESG factors. One method to achieve this is requiring pension trustees to consider in their investment policies not only financial but also ESG aspects of investee companies’ performance and report annually on how they have taken these factors into account.

²³ [2013] UKSC 26 at [73].

- 5.69 Meanwhile Royal London Asset Management queried our use of labels such as “ESG” in these circumstances.

Information can and should only be judged financial or non-financial, material or immaterial at the moment of making an investment decision and that information can theoretically come from anywhere so long as it passes the relevance test. Labels such as ethical, ESG, systemic, macroeconomic etc. are shorthand for areas of knowledge and should not grant any trustee permission to ignore those factors. The role of the fiduciary is to apply prudent judgement and skill (and to work with their advisors and investment managers) to understand which ethical or ESG issues (if any) at any given time are financially relevant to the mandate.”

A wide set of criteria that can be applied in many ways

- 5.70 The ESG label is applied in many ways. To some it involves taking into account a very wide range of factors. For example, GMIRatings provided us with a list of 150 separate issues that it used to judge companies, ranging from traditional governance factors (such as board composition, pay, ownership and control), through environmental impact (such as carbon emissions and water use) to social concerns (including human rights violations and child labour). AXA Investment Managers also stressed that ESG is about considering many different aspects:

What we are doing is capturing more signals about a company... Why would you ignore something that could give you a fuller picture of the company in which you are investing?²⁴

- 5.71 We explained that ESG factors can be used in a variety of ways, including to:

- (1) negatively screen – excluding investment in particular companies or sectors, such as tobacco companies or pesticide manufacturers;
- (2) positively screen – selecting firms engaged in what are considered to be desirable practices, such as renewable energy supply; or
- (3) select “best of sector” or “best of class” companies – choosing companies that perform best in their industry sector against specified indicators.²⁵

²⁴ See AXA Investment Managers, *White Paper: Piloting ESG Integration* (October 2012) p 9.

²⁵ A 2011 international survey by BNP Paribas of 259 institutional investors in 11 countries, including the UK, found that almost half that considered “wider” investment factors obtained information from specialist ratings agencies. The survey showed that of those who considered wider investment factors used a combination of approaches. 43% adopted a normative negative screening approach, 59% adopted a sector screening approach and 66% adopted a positive screening approach. BNP Paribas Investment Partners, *SRI Insights: Adding value to investments* (2012) vol 2 pp 58, 60-61.

5.72 We said that ESG factors can also be used in both passive and active strategies. For example, a passive mandate might track an index such as the FTSE4Good series (managed by a policy committee using complex inclusion criteria) or one of the S&P DJSI Diversified indices (which adopt a “best of sector” approach). An active mandate might select an investment manager or fund on the basis of their stated policy on investment factors. Alternatively, it might specify precisely which factors investment managers ought to take into account and how.

5.73 ShareAction commented that this description was too narrow. Instead, ESG criteria can be factored into any decision-making, both to select stock and to engage with companies.

This does not capture the type of ESG integration practised by an increasing number of mainstream investors, whereby ESG criteria are routinely factored into investment analysis and corporate governance activity, but without the application of specific ESG “screens”. In addition, this characterisation focuses almost exclusively on stock selection, and does not mention shareholder engagement on ESG issues with the aim of adding value at company level.

5.74 In the Consultation Paper, we drew attention to various studies showing that taking account of ESG factors has a positive financial impact.²⁶ A widescale literature review found that, over three to ten year time scales, companies that scored well for ESG factors outperformed or yielded comparative returns to others and were a lower risk as measured by the cost of equity and debt capital.²⁷ However, some factors were more significant than others. The main benefits were from environmental and governance ratings. Negative screening on the basis of socially responsible investing generally had neutral or mixed results.²⁸

5.75 As the use of investment factors evolves, we will learn more about which of the many factors currently captured within the ESG umbrella are the most significant in controlling risk. Meanwhile, the ESG label has been applied to many different forms of analysis and decision making. To claim an ESG approach it is not necessary to look at all possible environmental, social *and* governance factors. It can be used by those focusing on any one or more of a wide range of issues, from executive pay to use of fossil fuels. It is also becoming much more integrated into a mainstream approach. As Paul Todd, head of investment policy at NEST put it:

In future we suspect that the ESG debate will stop being a separate discussion and become just another element of long-term investing, in the same way that market and liquidity risk would not be separated out from the overall investment process.²⁹

²⁶ CP 215 para 10.50.

²⁷ See Deutsche Bank Group, DB Climate Change Advisors, *Sustainable Investing: Establishing Long-Term Value and Performance* (June 2012) pp 5, 38.

²⁸ Above, p 5.

²⁹ AXA Investment Managers, *White Paper: Piloting ESG Integration* (October 2012) p 6.

Conclusion

- 5.76 Given that “ESG” is a portmanteau concept, covering so many different factors, and used in so many different ways, it would not make sense to say that trustees must take an ESG approach. However, bearing in mind the comments from ShareAction and others, we think it would be helpful to make it clear that trustees should take account of risks to their investments. When investing in long-term equities, this includes risks to the long-term sustainability of a company’s performance. It is a matter for trustees and their financial advisers to consider what these risks might be and how they should be evaluated. In doing so, they should bear in mind that both “ESG” and “ethical” factors may, in any given case, be material to the performance of an investment.

STEWARDSHIP: BEYOND THE REACH OF SMALL FUNDS?

The approach of the Kay Review

- 5.77 Professor Kay saw stewardship as a central function of equities markets,³⁰ requiring relationships between investors and investee companies based on understanding and engagement. The Review comments that it is the quality rather than the amount of engagement which matters.

The issue that concerns us is not whether there is too much or too little shareholder engagement. It is whether the messages that managers and shareholders convey to each other, at meetings and through the share price, provide a framework within which companies and their boards can make balanced assessments of the measures needed to promote the success of the company in the long-run. Shareholder engagement is neither good nor bad in itself: it is the character and quality of that engagement that matters.³¹

³⁰ J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012) p 10.

³¹ Above, para 1.30.

- 5.78 Instead, Professor Kay advocated fewer and deeper relationships based on trust and respect, which favoured “voice” over “exit”. He commented that the reality was very far from this ideal:

The structure of the industry favours exit over voice, and gives minimal incentives to analysis and engagement. Many respondents clearly regarded engagement with companies as a cost. One of the largest UK asset managers, with both active and passive funds under management, told us that “engagement with investor companies requires investment of time and resource which can be seen as an encumbrance in a situation where mandates are being awarded based on fees”. Many of these respondents nevertheless accepted that such engagement was a responsibility of the asset manager: some thought it should be paid for, as a distinct charge or a levy on all investors. A few respondents suggested that there was some evidence that activist fund managers could recover the costs of strong engagement through superior performance. This lack of incentive for engagement is an inescapable feature of an investment landscape characterised by a competitive fund management industry and the fragmented holding of shares. Many respondents commented that the increased dispersion of share holding had aggravated this problem.³²

- 5.79 This raises issues about how far pension trustees can or should engage with the companies in which they invest, either directly or through their investment managers.

The UK Stewardship Code

- 5.80 The UK Stewardship Code states that “stewardship aims to promote the long term success of companies in such a way that the ultimate providers of capital also prosper”. The Financial Reporting Council (FRC), who are responsible for the Code, explain that it is designed:

to enhance the quality of engagement between asset managers and companies to help improve long-term risk-adjusted returns to shareholders. The Code also describes steps asset owners can take to protect and enhance the value that accrues to the ultimate beneficiary.³³

³² J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012) para 5.34.

³³ <https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx>.

5.81 The Code states that “stewardship is more than just voting”:

Activities may include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration. Engagement is purposeful dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings.³⁴

5.82 Based on the Code, we would define stewardship as promoting the long-term success of a company through monitoring and engagement, whether that engagement is formal (for example through voting) or informal (through communications and discussions).

5.83 The Code encourages all institutional investors to publicly disclose how they will discharge their stewardship responsibilities.³⁵ In addition, the Financial Conduct Authority (FCA) requires investment managers to disclose clearly the nature of their commitment to the Code. Where there is no commitment to the Code, the firm must explain its alternative investment strategy.³⁶

Responses to our Consultation Paper

5.84 In the Consultation Paper, we took the view that all but the very largest schemes lacked the internal resources or the financial clout to carry out effective stewardship. We quoted research by Tilba and McNulty which found that, of a sample of 35 of the largest 100 UK pension schemes, only 2 exhibited “engaged ownership behaviour” such as company research, voting and face-to-face meetings with senior management.³⁷

5.85 This statement was subject to significant criticism by consultees, who stressed that in practice stewardship responsibilities were often delegated to investment managers. The Financial Reporting Council, the body responsible for the UK Stewardship Code, told us that their definition was wider than simply “engaged ownership behaviour”, and that:

The Stewardship Code provides that asset owners’ commitment to the Code may not involve them engaging directly with companies, but instead indirectly through the mandates they give to asset managers.

³⁴ Financial Reporting Council, *The UK Stewardship Code* (September 2012) Principle 1, para 4.

³⁵ Financial Reporting Council, *The UK Stewardship Code* (September 2012) Principle 1.

³⁶ FCA Handbook COBS 2.2.3R. The rule only applies where a firm (other than a venture capital firm) manages investments for a professional client who is not a natural person.

³⁷ A Tilba and T McNulty, “Engaged versus disengaged ownership: the case of pension funds in the UK” (2013) 21(2) *Corporate Governance: An International Review* 165 at 171. The research also found evidence of “ownership behaviour” on the part of collective bodies such as the Local Authority Pension Fund Forum.

5.86 We were told that in practice, investors will satisfy their stewardship responsibilities through their investment managers. This might include terms in the investment manager's mandate, communication of stewardship policies to investment managers, and by holding investment managers to account for their stewardship activities. However, the FRC noted that although the Stewardship Code allows institutional investors to outsource stewardship activities to external service providers, responsibility for stewardship remains with the investor.

5.87 The Association of British Insurers was critical of the suggestion that stewardship was only cost-effective for larger funds. They argued that:

Any cost-benefit analysis will be unique to the circumstances of each scheme, taking account of a number of factors, and it would be inappropriate to generalise given the risk of negative unintended consequences for market practice. This is particularly acute when a cost-benefit analysis is only considered in the context of the narrow interpretation of stewardship i.e. only direct company engagement.

5.88 F&C Investments also stressed that stewardship was open to small funds through alternative means:

Small funds can pool their stewardship activities with other pension funds either through collective engagement groups (e.g. the Local Authority Pension Fund Forum) or through outsourcing stewardship activities to engagement and/or voting overlay service providers. Such third-party solutions allow pension funds to benefit from dedicated experienced resource and economies of scale enjoyed by the providers and their clients, while keeping costs reasonably low.

Comment

5.89 We accept that our analysis of stewardship in the Consultation Paper may have been too narrow. Trustees, similarly to other investors, may clearly delegate their stewardship activities to agents such as investment managers. This means that even small to medium-sized schemes can be involved in stewardship activities.

5.90 This emphasis on delegation means that stewardship of the UK equity market is now concentrated in a few large investment houses, together with three or four large pension funds and some charities, such as the Church Commissioners. In the Consultation Paper we explained that both Aviva and Legal & General employ corporate governance teams. Legal & General is one of the country's largest shareholders, responsible for managing approximately 4% of shares in all companies in the FTSE 350. This gives it some clout in dealing with companies. It told us that in 2012 it took part in 9,475 votes arising in 591 AGMs and 132 EGMs in the UK. More significantly, it held 490 meetings with individual boards.

5.91 Although delegating stewardship to investment organisations allows some engagement to take place, the result is likely to be well short of the Kay ideal. Investment managers may receive conflicting instructions from among their clients, leading to a “lowest common denominator” approach to stewardship. We were told by stakeholders that whilst it is possible to achieve agreement on issues such as executive pay, it is difficult to achieve a consensus among institutional investors on more difficult issues. And even where there is general concern over executive pay, and the largest shareholders work together, they may still fall well short of a majority. These, however, are more general problems with equities markets, which fall outside our terms of reference.

A duty to undertake stewardship activities?

5.92 In 2000, the Government commissioned the Myners Review to consider whether there were factors distorting the investment decision-making of institutions. The Review found that effective intervention, when appropriate, was in the best financial interests of beneficiaries. The Review noted that “as such, it is arguably already a legal duty of both pension fund trustees and their fund managers to pursue such strategies”, but that to put this beyond doubt, “the principle should in due course be more clearly incorporated into UK law.” The Review noted that this was the position in the United States, and quoted an interpretative bulletin issued by the US Department of Labor which stated that:

The fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares ... The fiduciary obligations of prudence and loyalty to ... beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the value of the plan’s investments.³⁸

The Review took the view that:

Managers should routinely consider the possibility of intervening in investee companies as one of the means of adding value for their clients. In this regard, it would be helpful if pension funds themselves recognised the possibility of added value through intervention, and regularly sought evidence from managers to demonstrate that they were active in this way.³⁹

5.93 In the event, the Government rejected Myners’ recommendation and favoured the voluntary approach of the Stewardship Code.

³⁸ 29 Code of Federal Regulations § 2509.94-2. This has now been superseded by a new interpretative bulletin: see 29 Code of Federal Regulations § 2509.08-2.

³⁹ P Myners, *Institutional Investment in the United Kingdom: A Review* (March 2001) paras 5.90-5.91.

5.94 It was suggested to us that stewardship should be made an explicit part of trustees' duties. The National Association of Pension Funds told us that stewardship benefits companies, investors and the economy as a whole, and that:

robust independent research makes it increasingly clear that active stewardship and integration of ESG factors within investment decisions may lead to improved risk-adjusted performance; it certainly shouldn't lead to detrimental returns and will likely provide protection against potential value destruction.

5.95 In Chapter 3,⁴⁰ we discussed the case of *Bartlett v Barclays Bank Trust Co Ltd*, where trustees were found liable for having failed to use their controlling position in a company to protect the trust's investments. Our view is that the duty recognised by this case will only arise in cases where a trust's shareholding confers a substantial measure of control over a company.⁴¹ Where the duty does apply, it is limited to ensuring that the company's assets are administered cautiously, with a view to safeguarding the trust's investments.

5.96 The concept of stewardship, on the other hand, is broader: it encompasses positive engagement with a view to increasing the value of a company over the long term. We do not think that the duty in *Bartlett* requires trustees to "promote the long term success of companies" in which the trust has a holding in some general way,⁴² particularly where the trust has only a small holding in a major public company. Whilst we recognise the importance of stewardship, our view is trustees have discretion over how far to engage with companies and to exercise their voting rights.

5.97 Our conclusion is that, at present, there is no duty on pension trustees or other investors to undertake stewardship activities. Nor is there a direct duty on investment managers, provided that they explain why they are not complying with the Stewardship Code. If the Government wished to go beyond the "comply or explain" approach of the Stewardship Code, this would require a change in the law.

⁴⁰ See paras 3.86 to 3.88 above.

⁴¹ This is the view taken by the editors of *Lewin on Trusts* (18th ed 2012) paras 34-49 to 34-50.

⁴² The Financial Reporting Council's Stewardship Code states that "stewardship aims to promote the long term success of companies in such a way that the ultimate providers of capital also prosper": see Financial Reporting Council, *The UK Stewardship Code* (September 2012) p 1.

5.98 That said, it is clearly in the interests of pension funds as a whole to do all they can to promote the long-term success of the companies in which they invest. We think that trustees should be encouraged to consider whether and how to engage with companies to promote their long-term success, either directly or through their investment managers. In Chapter 7 we recommend that the Government reviews the matters a statement of investment principles (SIP) is required to cover. We recommend that the reference to trustees' policy on "social, environmental or ethical considerations" should be amended to distinguish more clearly between financial and non-financial factors. We also think that there should also be a specific requirement that the SIP contain a statement of trustees' policy (if any) on stewardship.

CONCLUSION

- 5.99 Our discussion of pension trustees' duties to invest in the best interests of members was the subject of numerous consultation responses. Whilst consultees largely agreed with our interpretation of the law, there were concerns about our use of terms and our failure to recognise the role of the employer in DB schemes.
- 5.100 In light of these responses, we have revisited the expression and detail of our conclusions. In particular, we agree that the use of labels such as "ESG" and "ethics" is liable to cause confusion. The key distinction is between those factors which are financially material and those which are not. This is the basis on which we have set out our current thinking on these issues in the next chapter.
- 5.101 Consultees queried our view that stewardship was beyond the reach of small funds. It was said that it is open to asset owners to engage in "indirect" stewardship by delegating this function to their investment managers. We accept that smaller pension funds may contribute to stewardship in this way. Our analysis of the current law is that the issue is a matter of trustee discretion.
- 5.102 In the next chapter, we draw on this discussion to set out the Law Commission's final view on the current law. In Chapter 7, we consider whether more needs to be done to clarify this area.

CHAPTER 6

FACTORS IN PENSION TRUST INVESTMENT: THE LAW COMMISSION'S VIEW

- 6.1 As we have seen, a central concern of this review is how far pension trustees are required to focus on maximising financial returns, rather than considering wider factors, such as environmental or social impact or ethical standards. Paragraph 2 of our terms of reference asks us:

To evaluate what fiduciary duties permit or require such persons to consider when developing or discharging an investment strategy in the best interests of the ultimate beneficiaries: in particular, the extent to which fiduciaries may, or must, consider:

- (a) factors relevant to long-term investment performance which might not have an immediate financial impact, including questions of sustainability or environmental and social impact;
 - (b) interests beyond the maximisation of financial return;
 - (c) generally prevailing ethical standards, and / or the ethical views of their beneficiaries, even where this may not be in the immediate financial interest of those beneficiaries.
- 6.2 In this Chapter we provide the Law Commission's conclusions on how the courts would approach these issues. Given the paucity of decided cases, this has not simply been an exercise in stating "black letter" law as found in textbooks. Instead, we have considered the principles behind the various branches of law we have identified, and applied them after wide consultation with those involved.
- 6.3 We start with an overview of the legal duties of pension trustees when considering an investment strategy. We then look more specifically at how trustees may (or must) consider financial and non-financial factors. We draw on the Consultation Paper and the responses we received (as discussed in Chapter 5) to provide a final view.

THE DUTIES OF PENSION TRUSTEES: AN OVERVIEW

- 6.4 The duties of a trustee when considering an investment strategy arise from several sources, including the trust deed, pensions legislation, duties attached to the exercise of a power, duties of care and fiduciary duties. They are discussed in Chapters 3 and 4, and may be summarised as follows.

Acting for the purpose for which the power is given

- 6.5 The core duty of a trustee is to promote the purpose for which the trust was created.¹ A trustee should start with the trust deed and ask: what is the purpose of the power I have been given, and how can I use the power to promote that purpose?
- 6.6 In the case of a pension scheme, the primary purpose of the investment power is to generate returns to provide members with retirement and other benefits. In the case of DB schemes this enables the fund to act as a hedge against the employer's guarantee, while minimising burdens on the employer which might imperil the continuity and proper development of its business. In the case of the DC schemes it is to increase members' pension pots to provide financial benefits on retirement.

The investment regulations

- 6.7 Next, trustees must act within the confines of the legislation. This includes the Pensions Act 1995, the Pensions Act 2004, and the Occupational Pension Scheme (Investment) Regulations 2005 (the Investment Regulations).
- 6.8 The Investment Regulations require an investment power to be exercised in a manner "calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole".² The aim is to balance risk against returns. The regulations also require the portfolio to be properly diversified to "avoid excessive reliance on any particular asset, issuer or group of undertakings".³
- 6.9 Although smaller schemes are excluded from parts of the regulations, we think that these two general principles would apply to all trust-based schemes as a matter of trust law.

Exercising discretion

- 6.10 Within these broad parameters, trustees must exercise their own discretion. There are no right answers: producing a good return over the relevant time period is not simply a matter of applying a mechanical calculation. Trustees have been given the task of formulating investment strategy because it is thought they are best placed to apply broad judgement in the interests of their beneficiaries.
- 6.11 The law requires that trustees go through the right procedure to reach their decision, keeping the purpose of the trust at the front of their minds. In practice, the more unusual the decision, the more trustees will need to show that they have reached the decision in the right way.

¹ Lord Nicholls, "Trustees and their Broader Community: Where Duty, Morality and Ethics Converge" (1996) 70 *Australian Law Journal* 205.

² Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 4(3).

³ Above, reg 4(7).

The procedure

6.12 We listed the various procedural duties in Chapter 3. Three are particularly relevant.

- (1) Most importantly, trustees must not “fetter their discretion”. They must genuinely consider how to achieve a pension for their members and must not simply apply a pre-existing moral or political judgment.⁴ For example, in *Cowan v Scargill*,⁵ the union trustees fettered their discretion by applying pre-existing policy without considering its effect on the diversity of the portfolio.
- (2) The trustees should consider relevant circumstances. This is not necessarily an onerous duty. As the court said in *Pitt v Holt*, there will not necessarily be a breach of duty even if the trustees’ deliberations have fallen short of the highest possible standards.⁶ But trustees should exercise fair and impartial judgment, regardless of their own political, moral or religious views.⁷
- (3) As the court stressed in *Martin*,⁸ pension trustees should take advice. This is now specifically required by section 36 of the Pensions Act 1995.

The duty of care

6.13 Overlying these various duties, trustees should act “with such care and skill as is reasonable in the circumstances”. Those who act in a professional capacity or who hold themselves out as having special knowledge or experience will be held to a higher standard than lay trustees.⁹

6.14 The standard of care must be judged at the time the decision was made, not with hindsight.

“Best interests”

6.15 Overall, we think that the requirement on pension trustees to act in the best interests of beneficiaries can be seen as a bundle of duties. It is a short-hand for all the duties we have set out above.

⁴ See *Martin v City of Edinburgh District Council* [1989] Pens LR 9 at [33], 1988 SLT 329 at 334.

⁵ [1985] Ch 270.

⁶ [2013] UKSC 26 at [73].

⁷ *Martin v City of Edinburgh District Council* [1989] Pens LR 9 at [33], 1988 SLT 329 at 334.

⁸ [1989] Pens LR 9, 1988 SLT 329.

⁹ Trustee Act 2000, s 1. The duty of care under section 1 of the 2000 Act does not apply to occupational pension scheme trustees in relation to their powers of investment: Trustee Act 2000, s 36(2). Instead, they are subject to a duty of care under the general law and the provisions of the Pensions Act 1995. Importantly, under the general law the same duty of care ordinarily applies to all trustees irrespective of whether they are lay trustees or professional trustees and irrespective of any special knowledge or experience that they may have: *Lewin on Trusts* (18th ed 2012) para 34-09. Trust corporations may be held to a higher standard: *Bartlett v Barclays Bank Trust Co Ltd* [1980] Ch 515 at 534. The position in Scotland differs: see para 3.73, footnote 142, above.

THE STATEMENT OF INVESTMENT PRINCIPLES (SIP)

- 6.16 As discussed in Chapter 4, pension trustees must prepare a SIP stating their policy on the kinds of investments to be held and the extent (if at all) to which social, environmental or ethical considerations are taken into account. This does not give trustees special authority to consider social, environmental or ethical issues. Any investment strategy in the SIP must accord with the general law.¹⁰
- 6.17 Trustees must exercise their powers with a view to giving effect to those principles “so far as reasonably practicable”.¹¹ The legislation also requires trustees to review and, if necessary, revise the SIP.¹² A SIP might be considered a fetter on discretion if it were applied blindly after circumstances had changed.
- 6.18 The Investment Regulations require trustees to consult the scheme employer in drawing up the SIP.¹³ However, neither the SIP nor the trust instrument may restrict the power to make investments by requiring the employer’s consent.¹⁴ Pension trustees may consider the views of the employer but are not required to act in accordance with them. They must exercise independence of thought and use their powers for the purpose for which they were given.

DELEGATION

- 6.19 Under the Pensions Act 1995, trustees may delegate decisions about investments to an investment manager. Usually, trustees *must* delegate “day-to-day” decisions, as managing assets belonging to another person, in circumstances involving the exercise of discretion, is a regulated activity requiring FCA authorisation.¹⁵ Whilst some pension trustees are authorised, the vast majority are not.
- 6.20 The effect of these rules is that pension trustees without Financial Conduct Authority (FCA) authorisation may not pick stock but instead should focus on strategic decisions. These include the SIP, general asset allocation and the appointment of one or more investment managers. Trustees may question investment managers over their approach to risks and returns, may exercise discretion in selecting one over another, and may give their managers more or less detailed mandates over the approach to follow.

FINANCIAL AND NON-FINANCIAL FACTORS

- 6.21 We have been asked to consider how far trustees may (or must) consider factors relevant to long-term investment performance; interests beyond the maximisation of financial returns; and ethical views, even where this may not be in the immediate financial interest of those beneficiaries.

¹⁰ Nabarro Pensions Team, *Pensions Law Handbook* (11th ed 2013) para 10.26.

¹¹ Pensions Act 1995, s 36(5).

¹² Above, s 35(1)(b).

¹³ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 2(2)(b).

¹⁴ Pensions Act 1995, s 35(5).

¹⁵ For further discussion, see paras 4.13 to 4.16 above.

- 6.22 Below we explain why we do not think that it is helpful to suggest that trustees should only maximise financial returns. The most important distinction is between factors relevant to increasing returns or reducing risks (financial factors) and those which are not (non-financial factors).¹⁶

Balancing returns against risks

- 6.23 Trustees are required to balance returns against risk. The primary aim of their investment strategy should be to secure the best realistic return over the long-term, given the need to control for risks. We would emphasise that this is often a question of broad judgment – and must be judged at the time of the decision, not in hindsight.

FINANCIAL FACTORS

- 6.24 By financial factors we mean any factor which is relevant to trustees' primary investment duty of balancing returns against risks.

The risks to a company's long-term sustainability

- 6.25 The risks (and factors relevant to the risk) will depend on the type of investment. When investing in long-term equities, the risks will include risks to the long-term sustainability of a company's performance. These may arise from a wide range of factors, including poor governance or environmental degradation, or the risks to a company's reputation arising from the way it treats its customers, suppliers or employees. A company with a poor safety record, or which makes defective products, or which indulges in sharp practices also faces possible risks of legal or regulatory action.
- 6.26 Often these risks will involve breaches of prevailing ethical standards. However, where poor business ethics raise questions about a company's long-term sustainability, we would classify them as a financial factor, rather than what the Consultation Paper referred to as a "purely ethical" concern.

Trustee may take all these factors into account

- 6.27 Trustees *may* take account of any factor which is financially material to the performance of an investment, including environmental, social and governance factors. Professor Kay noted that most lawyers he talked to agreed with this view, but uncertainties remained. As ShareAction commented, this is "partly down to the persistence of myths and misconceptions about fiduciary duty".¹⁷
- 6.28 Our own consultation has reached the same conclusion. There is general agreement that wider investment factors may be considered, but concern that pension trustees may continue to receive risk averse legal advice on the issue.
- 6.29 We hope that we can finally remove any misconceptions on this issue: there is no impediment to trustees taking account of environmental, social or governance factors where they are, or may be, financially material.

¹⁶ See discussion at paras 5.48 to 5.56 above.

¹⁷ ShareAction, Response to "Fiduciary Duties of Investment Intermediaries: Initial Questions" (July 2013)..

Trustees should take financially material factors into account

- 6.30 Whilst it is clear that trustees may take into account environmental, social and governance factors in making investment decisions where they are financially material, we think the law goes further: trustees *should* take into account financially material factors. As a leading text notes:

Trustees should have regard to whatever risks may affect an investment, and balance them against its yield. A good example of that is where before 1994 trustees took the view that apartheid posed undue political risks to an investment in South Africa, and it would have been difficult to make trustees liable for refusing to expose their fund to such risks if they genuinely considered the question and decided in good faith to avoid them in the interests of their beneficiaries.¹⁸

- 6.31 However, we do not think it is helpful to say that ESG or ethical factors must always be taken into account. These labels are ill-defined and liable to cause uncertainty. The fact that a particular factor is conventionally classified as an “ESG” or “ethical” factor will not be conclusive as to whether it is financially material or not. Nor will a factor that is financially material in respect of one investment always be financially material in respect of others. In every case, the test must be: what are the risks associated with this investment?
- 6.32 It is for trustees’ discretion, acting on proper advice, to evaluate these risks. This will include an assessment of which factors are financially material and the weight they should be given. Trustees may sensibly decide to give factors which are more difficult to assess and quantify less weight than others. Certain risks may be financially material for some investors and not for others: a pension scheme with long-term liabilities may give greater weight to the governance risks associated with investing in a particular company than an institutional investor investing over the short-term. The law does not prescribe a particular approach.

NON-FINANCIAL FACTORS

- 6.33 By “non-financial factors” we mean factors which might influence investment decisions motivated by other (non-financial) concerns, such as improving members’ quality of life or showing disapproval of certain industries. In broad terms, trustees should take into account financially relevant factors. However, the circumstances in which trustees may make non-financially related decisions are more limited.
- 6.34 In general, non-financial factors may only be taken into account if two tests are met:
- (1) trustees should have good reason to think that scheme members would share the concern; and
 - (2) the decision should not involve a risk of significant financial detriment to the fund.

¹⁸ *Lewin on Trusts* (18th ed 2012) para 35-63 (footnote omitted).

- 6.35 The courts will focus on the process by which trustees reach their investment decisions, rather than the outcome of those investments. They will examine whether the trustees applied their minds to the right issues and went about the decision in the right way.
- 6.36 There are two exceptions, where these tests do not need to be applied. These are: decisions authorised by the trust deed; or, in defined contribution (DC) schemes, where the beneficiary has chosen to invest in a specific fund. It is possible that the courts may also allow a greater margin for non-financial factors in pension funds where the members share a particular moral or political viewpoint.

Differences between general trust law and pensions

- 6.37 It is a rule of trust law that trustees may safely depart from the provisions of the trust instrument or take an administrative step not authorised by the instrument or the general law if all the beneficiaries affected are of full age and capacity and agree to this being done.¹⁹ However, we think that this may have limited application in a pensions context. A pension trustee's power of investment is heavily constrained by legislation, and the courts have expressed concerns about lifting wholesale rules that have been developed in the context of traditional trusts and applying them to trusts of a different kind.²⁰ For these reasons, we do not think that this rule would allow trustees to ignore the tests we have set out in the unlikely event that unanimous consent was given.
- 6.38 In *Buschau v Rogers Communications Inc.*,²¹ the Supreme Court of Canada refused to allow a rule of trust law to be invoked in the pensions context which would allow the beneficiaries to act together to terminate the trust and distribute its assets as they saw fit. The court stressed the importance of the legislative framework and the employer's interest.

Three examples of non-financial concerns

- 6.39 Below we outline three examples of non-financial concerns which might motivate trustees in their investment strategy. These are: decisions aimed to improve the beneficiaries' quality of life in a non-financial way; decisions aimed at showing disapproval of unethical businesses; and decisions aimed at improving the UK economy. We then look in detail at the tests, before considering the exceptions.

¹⁹ *Lewin on Trusts* (18th ed 2012) para 45-03.

²⁰ See *Target Holdings Ltd v Redferns* [1996] AC 421 at 435.

²¹ [2006] 1 SCR 973. The rule in question was what is commonly known as "the rule in *Saunders v Vautier*", which states that the beneficiaries of a trust, where they are all of full age and capacity and are in agreement, may act together to require the trustees to terminate the trust and transfer the trust property to them to distribute as they see fit.

Decisions aimed at improving beneficiaries' "quality of life"

- 6.40 It is suggested that pension trustees should be able to take into account the beneficiaries' quality of life now and in the future. For example, one writer argues:

Apart from a good retirement income, pension fund members also desire a clean, safe and secure world. Given the ubiquity of pension fund membership, the interests of members should be broadly consistent with those of the society in which members live.²²

- 6.41 Several stakeholders raised issues about the human cost of environmental degradation and climate change. The Freshfields Report commented:

Many people wonder what good an extra percent or three of patrimony are worth if the society in which they are to enjoy retirement and in which their descendants will live deteriorates. Quality of life and quality of the environment are worth something, even if, or particularly because, they are not reducible to financial percentages.²³

- 6.42 "Quality of life" may also be a factor in deciding whether to invest in local infrastructure and social projects. Some local authority pension funds invest in infrastructure projects partly on this basis. For example, Strathclyde Pension Fund puts a proportion of its investment into a New Opportunities Fund which aims to create local jobs or benefits to the local community while delivering returns. However, pension trustees aim to receive at least equally beneficial financial returns. For example, a study of 100 local authority pension funds by the Smith Institute showed that none would be prepared to accept lower returns in exchange for achieving social benefit; they saw "finance first" as their overriding duty.²⁴

- 6.43 In the Consultation Paper we argued that quality of life objectives "have to remain a subordinate investment objective".²⁵ This is important to remember where trustees face pressure to invest in "the issue of the day". As one commentator notes:

Schemes are being regarded, following the collapse of our banking framework, as the magic porridge pot out of which the money for the roads and railways we need can be found.²⁶

²² B Richardson, "Do the Fiduciary Duties of Pension Funds Hinder Socially Responsible Investment?" (2007) 22(2) *Banking and Finance Law Review* 145 at 170.

²³ Freshfields Bruckhaus Deringer, *A legal framework for the integration of environmental, social and governance issues into institutional investment* (October 2005) p 3.

²⁴ The Smith Institute, *Local authority pension funds: investing for growth* (September 2012) p 18.

²⁵ CP 215 para 10.94. See B Richardson, "Do the Fiduciary Duties of Pension Funds Hinder Socially Responsible Investment?" (2007) 22(2) *Banking and Finance Law Review* 145 at 161.

²⁶ R Ellison, "Pointing the finger" (July 2013) *Pensions World* 14 at 14.

6.44 Trustees may look for good infrastructure schemes which will both improve quality of life *and* provide good financial returns. And where two projects appear equally beneficial, trustees may choose the investment which will most improve beneficiaries' quality of life. However, financial returns (to pay retirement and other benefits) are the primary objective.

6.45 Most consultees agreed that the emphasis on financial returns was correct. As Allen & Overy LLP said:

Pension schemes are, and should be a medium for the provision of pensions and related financial benefits to members and their dependants and should not be seen as a medium for the implementation of social or economic policy or the funders of infrastructure projects.... There are many infrastructure projects in which pension schemes feel able to invest but they are judged, and in our view should be judged, on their financial merits. A pensioner expects, and requires, a level of income for old age and we cannot see why that income should be placed in doubt by the provision of a highway, hospital or other services elsewhere in the country (or even in the pensioner's locality).

6.46 Our conclusion is that quality of life factors are a subordinate objective, and are therefore subject to the two tests we set out below. Trustees should have good reason to think that beneficiaries would welcome the lifestyle benefit and there should be no risk of significant financial detriment to the scheme.

Decisions aimed at showing disapproval of unethical conduct

6.47 There are many examples of calls on pension funds to disinvest from particular industries or places. As we saw in Chapter 4, the recorded cases are largely about these issues. In *Harries*,²⁷ the Church Commissioners refused to invest in alcohol, tobacco and armaments firms. In *Cowan*,²⁸ the union called on the fund to disinvest from oil and gas, and from all overseas investments. In *Martin*,²⁹ there was a call to disinvest from South Africa at the time of the apartheid regime. Over the course of this project there was also media discussion over whether the Church Commissioners should invest in payday loans,³⁰ and whether local government pension authorities should invest in tobacco.³¹

6.48 A clear distinction needs to be drawn between decisions to disinvest based on financial factors and those based on a desire to show moral disapproval. It is the difference, for example, between withdrawing from tobacco because the risks of litigation make it a bad long-term investment, and withdrawing from tobacco because it is wrong to be associated with a product which kills people.

²⁷ [1992] 1 WLR 1241.

²⁸ [1985] Ch 270.

²⁹ [1989] Pens LR 9, 1988 SLT 329.

³⁰ See CP 215 para 10.100.

³¹ Following these concerns, the LGPS Advisory Board took advice from Nigel Giffin QC: see paras 4.77 to 4.78 above.

6.49 As we explore below, it may be legally permissible for trustees to disinvest because of concerns that it is wrong to be associated with a product which causes harm. However, trustees would need to show that they had gone through a careful process to apply the two tests we set out. They would need good reason to think that scheme members shared their concern; and that the decision did not risk significant financial detriment to the scheme.

Decisions aimed at improving the UK economy

6.50 In their response to our short paper, UNISON pointed out that pension trustees “are owners not of just a handful of assets, but of a slice of the economy as a whole”. As the performance of investment funds “is directly correlated to the overall performance of the British and world economy”, it is said that trustees ought to consider the effect of their decisions on the economy as a whole. This theory is often described as “Universal Ownership” and is strongly promoted by Hawley and Williams. They contend that:

... the time has come for institutional investors to explicitly recognize that economy-wide, macroeconomic issues heavily influence the returns they will earn on their investments.³²

6.51 This raises questions where, for example, a major British company faces a take-over bid from a foreign firm. Should the trustees vote in favour on the ground that the scheme would make money from the deal, or against on the ground that the deal would damage the UK economy?

6.52 Trustees should consider beneficiaries’ interests and the impact of any takeover on the scheme’s assets in deciding how to act. The question trustees would need to consider is whether the potential damage to the UK economy is a financial factor or a non-financial factor.

6.53 In some circumstances, damage to the wider economy might be considered a financial factor, as it will impact on the scheme’s portfolio as a whole. The wider economic effect of a takeover may impair trustees’ ability to generate returns over the longer term. In the Consultation Paper we said that the aim of a pension fund is to secure returns across the whole portfolio. Therefore there can be no legal objection to making a decision which, after due consideration, is designed to provide financial benefits to the portfolio as a whole. In such a case, voting against the takeover may be in beneficiaries’ best interests. However, for the decision to be justified on financial grounds, the anticipated benefits to the portfolio should outweigh the likely costs to the portfolio. In other words, the financial benefit must not be “too remote and insubstantial”³³ and must accrue to the fund itself, not to the social good in a more general way.

³² J Hawley and A Williams, *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic* (1st ed 2000) p 22.

³³ *Cowan v Scargill* [1985] Ch 270 at 292.

- 6.54 In practice, pension funds are not heavily invested in UK equities. In the Consultation Paper we noted that pension funds had moved away from equities to safer asset classes such as bonds, and away from the UK to more international portfolios. The schemes we talked to told us that less than 10% of their holdings were in UK equities. Meanwhile, as more foreign investors move into the UK market, pension funds now make up only a small minority of all UK share owners.
- 6.55 This means that many schemes would find it difficult to favour the UK economy on purely financial grounds. Their future returns depend more on the world economy than on the UK one – so what is good for, say, a US firm may be good for UK pension funds, if a strong US economy would drive world-wide growth.
- 6.56 In these circumstances, a decision to favour the UK economy is more likely to be a non-financial one rather than a financial one. We think that it would be subject to the same tests as apply to decisions motivated by a desire to improve beneficiaries' quality of life in non-financial ways, or to show disapproval for unethical conduct. Again, trustees would need good reason to think that members would wish to protect the UK economy; and that the decision did not risk significant financial detriment to the scheme.

THE TESTS FOR APPLYING NON-FINANCIAL FACTORS

Test 1: Do trustees have good reason to think that scheme members share the concern?

- 6.57 The courts have made clear that trustees may not impose their own ethical views on their beneficiaries. As the court noted in *Harries*, trustees “must not use property held by them for investment purposes as a means for making moral statements”.³⁴ In *Martin*, Lord Murray recognised that it may not be possible for a fiduciary to “divest himself of all personal preferences, of all political beliefs, and of all moral, religious or other conscientiously held principles”.³⁵ Nevertheless, they must do their “best to exercise fair and impartial judgment” in the interests of the beneficiaries. If they cannot do this, they should abstain from deciding the issue or, in an extreme case, resign as a trustee.³⁶

³⁴ *Harries v Church Commissioners* [1992] 1 WLR 1241 at 1247.

³⁵ [1989] Pens LR 9 at [33], 1988 SLT 329 at 334.

³⁶ Above.

6.58 Rosy Thornton has noted that:

individuals who serve as trustees, or who are employed by firms acting as corporate trustees, have consciences, too; they are no doubt affected by the same personal moral, social and political promptings as any private individual, whether the trust in question be a traditional family trust, a pension fund or a charity. Trustees, however, are not free, as ordinary citizens would be, to follow their conscience when investing the trust assets which are under their stewardship.³⁷

6.59 Whilst cases such as *Harries* are clear that trustees may not impose their own views on beneficiaries, they also envisage that, in some cases, non-financial criteria may be taken into account when investing.³⁸ Most consultees agreed that trustees must reflect the views of their beneficiaries (or the views their beneficiaries would have if they addressed the question), rather than their own views. As Eumedion put it, “the morality and ethics pension funds apply should essentially be those that would be appropriate to the beneficiaries”.

6.60 However, several consultees thought that this was easier said than done. The Association of British Insurers said it would be “difficult to establish a consensus”. Allen & Overy LLP commented:

Outside narrow and extreme circumstances it seems improbable that there is any generally prevailing view on a wide range of issues on which individuals may hold different opinions, from payday lending at high interest rates, to armaments manufacture, to the use of low rate labour in developing countries.

6.61 Dr Magda Raczynska and Professor Duncan Sheehan added that:

In a large pension fund – or even most smaller ones – the idea that one could identify the scheme members’ views is worrisome. The most that could be done is to go on the basis of some democratic opinion poll, but that would seem to fetter the trustees’ discretion, and in any case leave a sour-taste at the pure majoritarianism of the mechanism... The idea that the membership of the Universities’ Superannuation Scheme has a view on investing in arms’ firms for example seems to us implausible.

³⁷ R Thornton, “Ethical Investment: a case of disjointed thinking” (2008) 67(2) *Cambridge Law Journal* 396 at 397.

³⁸ See, for example, *Harries v Church Commissioners* [1992] 1 WLR 1241 at 1247.

The test in practice

- 6.62 Consultees asked for more detail about this test. In particular, what proportion of beneficiaries need to agree, and how can this be proved? For example, NEST Corporation asked:

We think it's worth discussing further how fiduciaries might understand beneficiaries' ethical views better and how it might be appropriate to use beneficiaries' views as a reference point. Even within particular interest groups there's rarely unanimity of view, indeed *Harries v Church Commissioners* arose from a difference of opinion within a section of the Church of England. The salient question for multi-employer schemes is how far unanimity of view is required in a diverse population in order to take an ethical stance? If 95 per cent of beneficiaries are opposed to an investment with the remainder neutral is that sufficient?

- 6.63 We cannot give a prescriptive answer to these questions, but we think that the courts would judge the issue in the round, focusing on whether trustees applied their minds to the right question and sought an answer in a reasonable way.
- 6.64 We think that in some cases trustees can make assumptions about beneficiaries' views without carrying out surveys. In the Consultation Paper we remarked that trustees should not invest in activities which contravene international conventions, such as manufacturing cluster bombs which are banned by the Convention on Cluster Munitions.³⁹ It was pointed out that investing in foreign firms which make cluster bombs is not illegal under UK law, and we were asked to clarify why we said this. At a practical level it might also be difficult for trustees to know whether a particular company manufactures cluster bombs.
- 6.65 We accept that investment in cluster bombs is not necessarily illegal. But we think that the fact that there is an international agreement, ratified by the UK, which prohibits cluster bombs gives trustees reason to think that many people would consider them to be wrong. When coupled with letters from members agreeing, and no letters disagreeing, we think that trustees would have good reason to think that they were acting on members' concerns rather than their own. This may be an example where the evidential requirement to show that beneficiaries share the concern may be relatively light.
- 6.66 In other cases, a poll of members may be necessary. We do not think that there needs to be 100% agreement. If a majority are opposed to an investment while the rest remain neutral, we think that would be enough. It is the nature of pensions that many members will not engage with investment decisions, and the reason why default funds are so important.

³⁹ CP 215 para 14.25.

6.67 The more difficult questions arise where a majority think that the disinvestment should take place but a minority disagree strongly. Investment decisions may have different consequences for different beneficiaries. The courts have expressed concern when trustees favour one group over another, even if the favoured group are the majority. In *Cowan v Scargill*, it was said that trustees should hold “the scales impartially between different classes of beneficiaries”.⁴⁰ More recently, Mr Justice Hoffmann preferred to say that the trustee must act fairly in making investment decisions which may have different consequences for different classes of beneficiaries.⁴¹ We think that in cases where the issue is clearly controversial, the courts may well expect trustees to focus on financial factors rather than becoming embroiled in disagreements between the members.

Test 2: the decision should not risk significant financial detriment

6.68 In *Harries*, Sir Donald Nicholls VC stressed that the purpose of investment was to generate money. Other factors could be accommodated, but only “so long as the trustees are satisfied that course would not involve a risk of significant financial detriment”.⁴² Lord Nicholls later expanded on the principle, arguing that:

The inclusion or exclusion of particular investments or types of investment will often be possible without incurring the risk of a lower rate of return or reducing the desirable spread of investments.⁴³

The debate

6.69 We think it is clear that non-financial factors can be used if they do not cause significant financial detriment, but there has been considerable debate about how this test should be applied.

6.70 At one extreme, it has been said that any exclusion on non-financial grounds would damage trustees’ ability to diversify the portfolio and therefore cause financial detriment to the fund. Rosy Thornton argues that diversification is always beneficial: even if it cannot reduce systemic risk it will reduce firm-specific risk. She concludes that “any restriction adopted on ethical or other grounds will necessarily have an effect, however small, upon efficiency”.⁴⁴

⁴⁰ [1985] Ch 270 at 287, by Megarry VC.

⁴¹ *Nestle v National Westminster Bank* (1996) 10(4) *Trust Law International* 112 at 115. See discussion at paras 3.59 to 3.60 above.

⁴² [1992] 1 WLR 1241 at 1247.

⁴³ Lord Nicholls, “Trustees and their Broader Community: Where Duty, Morality and Ethics Converge” (1996) 70 *Australian Law Journal* 205 at 212.

⁴⁴ R Thornton, “Ethical investments: a case of disjointed thinking” (2008) 67(2) *Cambridge Law Journal* 396 at 407. For further discussion of this argument, see CP 215 paras 10.84-10.85.

6.71 The test has sometimes been described as the “tie-break” principle, where moral considerations can be used to decide between two equally beneficial choices.⁴⁵ This suggests that trustees could use non-financial criteria only in narrow circumstances as a way of distinguishing between two equal choices.

6.72 In the Consultation Paper we argued that the test should not be applied in this narrow way. The requirement is that trustees should not incur the risk of significant financial detriment to the scheme, not that they should avoid theoretical detriment according to a precise mathematical model. Increasing diversification is not necessarily an unmitigated good and we did not think that the courts require a portfolio to be diversified to the fullest extent possible. Instead it is a question of degree in each case, taking into account the nature of the scheme.⁴⁶ In *Harries*,⁴⁷ the Church Commissioners reached the view that excluding 13% of the market would be acceptable, while excluding 37% would not be. The court held that this decision did not err in law.⁴⁸ It was the trustees’ discretion and the court would not interfere.

6.73 Several consultees agreed that it was often possible to exclude limited classes of investment without financial detriment. For example, NEST Corporation agreed that trustees should have a “freer hand” to exclude some types of stock, noting:

The exclusion of limited numbers of stocks would have no material impact from a well-diversified portfolio.

6.74 It was said that the main advantages of diversification can be achieved at a relatively low level. ShareAction told us that that the benefits of diversification tail off dramatically above around 30 stocks - well below the thousands held by most UK pension funds.

The nature of the test

6.75 It is up to the trustees to decide whether a decision made on non-financial grounds risks causing significant financial detriment. The decision must be assessed at the time it is made, not in hindsight, and the courts will allow the trustees discretion in the way that they assess financial detriment.

⁴⁵ The Freshfields Report explains that this term was used by John Denham, the then Parliamentary Under Secretary of State at the Department of Social Security, in a speech in 1998: Freshfields Bruckhaus Deringer, *A legal framework for the integration of environmental, social and governance issues into institutional investment* (October 2005) p 97, n 392. It also notes that Sir Robert Megarry VC later endorsed the principle extra-judicially. He said: “If other things are equal, it may well be contended that an investment in A Ltd instead of B Ltd, made because the great majority of the beneficiaries oppose investments in B Ltd and so gratifying the majority, will neither harm nor benefit the minority, and so will in general be for the benefit of the beneficiaries at large.” See R Megarry, “Investing Pension Funds: The Mineworkers Case” in T Youdan (ed), *Equity, Fiduciaries and Trusts* (1989) 149 at 158.

⁴⁶ G Thomas and A Hudson, *The Law of Trusts* (2nd ed 2010) para 54.57.

⁴⁷ [1992] 1 WLR 1241.

⁴⁸ Above, at 1250.

- 6.76 However, the trustees must apply their minds to the question and take professional advice about it. In *Martin v City of Edinburgh District Council*,⁴⁹ the Court of Session found against the Council not because its decision to disinvest from South Africa was necessarily wrong, but because the Council had made the decision in the wrong way. It had applied a pre-existing policy: it did not consider whether it was in the best interests of the beneficiaries or seek professional advice on the issue.⁵⁰

The interaction between the two tests

- 6.77 We think that any decision made on non-financial grounds is subject to both tests. Trustees should consider each issue. Do we have good reason to think that scheme members would share the concern? And does the decision involve a risk of significant financial detriment? If the decision fails either test, trustees should not proceed.
- 6.78 However, we think that the ultimate decision should be looked at in the round, considering the evidence on both questions. For example, if trustees are faced with compelling evidence that members feel very strongly about the issue, then they may be justified in accepting a risk of some possible detriment, so long as that detriment is not significant. Conversely, if trustees receive clear professional advice that the decision is financially neutral, with some members agreeing and some indifferent, the trustees may still go ahead. The position may be different where only a modest level of agreement is combined with some risk of detriment.

May or must?

- 6.79 As we clarify above, trustees may make decisions on non-financial grounds which satisfy these two tests.
- 6.80 Here we consider whether trustees *must* act on their member's views. Alternatively, may they decide to ignore members' beliefs and concentrate exclusively on financial factors? NAPF pointed out that the process of obtaining views might distract trustees from their proper focus:

Even in circumstances where trustees can agree that consideration of ethical, moral or other preferences is appropriate, application of purely ethical considerations can become divisive and very political. It is difficult to develop a consensus view among trustees in order to establish a clear policy. Distilling the disparate views of the whole membership into a clear policy would be more difficult still and trustee boards will not wish to deflect focus from factors that more directly influence financial growth.

⁴⁹ [1989] Pens LR 9, 1988 SLT 329.

⁵⁰ [1989] Pens LR 9 at [24], [32], 1988 SLT 329 at 331-2, 334.

6.81 In the Consultation Paper we noted cases which state that trustees are obliged to make their own decisions: they should not act under the dictation or instructions of the beneficiaries.⁵¹ Academic commentators have made similar points: donees of powers must not act as “another’s puppet”.⁵² Nor do investors “have the right to dictate the design and implementation of the fund’s investment strategy to the fiduciary”.⁵³ Chris Hitchen, Chief Executive of the Railways Pension Trustee Company told the BIS Select Committee that the fiduciary duty which “goes to the core” of his job is:

not the same thing as doing what your members want you to do; it is about doing what is in their best interests, and those two things are not always the same.⁵⁴

We concluded that trustees may consider the views of the beneficiaries when making their investment decisions, but there is no legal requirement for them to do so.⁵⁵

6.82 As we have seen, in DB schemes, pension trustees have to weigh their duties to members against any possible threat to the employer’s ability to make contributions. They should be careful not to impose burdens which imperil the continuity and proper development of the employers’ business or make an avoidable call on the Pension Protection Fund. We accept that there are times in which discussion of non-financial factors would be a distraction from these core tasks. Our final conclusion is the one set out in the Consultation Paper. In DB schemes, we do not think that trustees are required to seek the views of their beneficiaries.⁵⁶

6.83 On the other hand, trust law is interpreted flexibly. In DC schemes, members bear both the benefits and the risks of the investment decision and should therefore be entitled to make informed ethical choices. We think that where the trustees of DC schemes are faced with members’ clearly articulated views they should attempt to provide a suitable choice of funds.

EXCEPTIONS: WHEN CAN SIGNIFICANT FINANCIAL DETRIMENT BE JUSTIFIED?

6.84 Finally we have considered whether there are any exceptions to the principles we have outlined. In particular, when does the law allow trustees to apply a non-financial factor which causes significant financial detriment to the pension fund?

⁵¹ See for example *Selby v Bowie* (1863) 8 LT 372 (instruction to accept a particular offer to purchase trust property) and *Re Brockbank* [1948] Ch 206 (instruction to appoint a particular person as trustee).

⁵² P Finn, *Fiduciary Obligations* (1st ed 1977) para 42.

⁵³ P Ali & K Yano, *Eco-finance: the legal design and regulation of market-based environmental instruments* (1st ed 2004) p 140.

⁵⁴ The Kay Review of Equity Markets and Long-Term Decision Making, Third Report of the Select Committee on Business, Innovation and Skills (2013-14) HC 603 at Ev 58.

⁵⁵ It is permissible for trustee to consult their beneficiaries: *Re Agricultural Industries* [1952] 1 All ER 1188 at 1190. However, trustees must make the ultimate decision: *Re Poole* (1882) 21 Ch D 397 at 404; *Re Smith* (1886) 17 QBD 488.

⁵⁶ This is subject to contrary provision in the trust instrument.

- 6.85 There are two clear exceptions where significant financial detriment is permitted:
- (1) Where the decision is expressly permitted by the trust deed;
 - (2) In DC schemes, where members may choose to invest in a specific fund.
- 6.86 Below, we also discuss whether different considerations apply to pension funds set up by “affinity groups”, such as religious, charitable or political organisations, where staff are particularly committed to certain ethical values.⁵⁷

Decisions permitted by the trust deed

- 6.87 The trust deed is the source of trustees’ powers, and trustees should act in accordance with it. Therefore, trustees may make any decision which is permitted by the deed, and must make any decision which is required by the deed. There can be no objection, for example, to the trustees failing to invest in a particular asset class where to do so is prohibited by the trust instrument.

Consent

- 6.88 If DC members choose to invest their money on the clear understanding that the investment criteria may lead to a lower return, then the trustees or other providers cannot be criticised.
- 6.89 In the Consultation Paper we noted that NEST Corporation offered both an ethical and a Shariah fund and we thought it was good practice for such schemes to provide these options where a demand is expressed for them. Several consultees told us that ethical investment did not necessarily lead to the financial detriment of beneficiaries. For example, F&C Investments commented:

On the contrary, there is growing evidence that ethical funds are now matching mainstream funds in key investment criteria such as performance and tracking error. Therefore, should some beneficiaries be shown to support ethical standards, our belief is that funds can be found that can meet these whilst not imposing a financial penalty.

- 6.90 We do not wish to imply that any particular fund will lead to financial detriment. For the purposes of this discussion we simply note that where a beneficiary has explicitly chosen for their contributions to be invested on an ethical basis, there can be no criticism of the trustees in the event that the beneficiary’s investments underperform.

Affinity groups

What is an affinity group?

- 6.91 In the Consultation Paper we noted the observation in *Harries* that charitable trustees should not be required to make investments which conflict with the aims of the charity.⁵⁸ Nor should they be required to make investments which would reduce support for the charity by alienating its donors or recipients.

⁵⁷ We discuss the role of unanimous consent at paras 6.37 to 6.38 above.

⁵⁸ CP 215 para 10.111.

- 6.92 In Chapter 4 we also refer to the observation in *Cowan v Scargill* that there may be an exception to the normal rules where “the only actual or potential beneficiaries of a trust are all adults with very strict views on moral and social matters”. Here it was said that “the beneficiaries might well consider that it was far better to receive less than to receive more money from what they consider to be evil and tainted sources.”⁵⁹
- 6.93 Here we use the term “affinity groups” to refer to schemes in which members share a particular moral or political viewpoint. This might arise where a pension fund is set up by a religious group, other charity or political organisation. For example, the pension fund of a cancer research charity may wish to disinvest in tobacco, even if their advisers told them that this would cause financial detriment.
- 6.94 However, not all pension funds set up by charities will necessarily be affinity groups. As was remarked wryly in *Harries*, not all members of the Church of England eschew gambling, alcohol or tobacco.⁶⁰ Similarly, other organisations may employ staff that take a relaxed view of their employer’s moral or political stance.

The importance of the trust deed

- 6.95 Ideally, the limitations imposed on trustees in these specialists schemes should be written into the trust deed and made explicit to all concerned. If, for example, the trust deed of a cancer charity’s pension fund prohibits the trustees from investment in tobacco, this restriction must be applied.

A more flexible test?

- 6.96 In the absence of specific provisions in the trust deed, we think that trustees of affinity groups should continue to ask the same questions: do beneficiaries share these views and what is the risk of financial detriment to the fund? However, we think that the courts would give trustees more flexibility in applying the answer. It is likely, for example, that a court would be more willing to find a consensus of views amongst members in an affinity group scheme than might otherwise be the case.
- 6.97 Furthermore, if faced with compelling evidence that all the members of the scheme felt very strongly about an issue, trustees may be justified in accepting a greater risk of detriment. To use the example in *Cowan v Scargill*,⁶¹ if members of a religious group condemned “all forms of alcohol, tobacco and popular entertainment, as well as armaments”, the trustees may be justified in accepting the lower returns to the fund which flowed from restricting investments in this way.

⁵⁹ [1985] Ch 270 at 288. See para 4.41 above.

⁶⁰ [1992] 1 WLR 1241 at 1250.

⁶¹ [1985] Ch 270.

- 6.98 Another consideration would also apply. In a DB scheme, trustees should take into account the impact of their investment decisions on the viability of the sponsoring employers' business, with a view to safeguarding the employers' funding covenant. When dealing with an employer charity, trustees are not required to make an investment which would reduce support for the employer by alienating its donors or recipients, or leaving it open to a charge of hypocrisy. Trustees will need to weigh this against the strength of the covenant and the risk of a call on the Pension Protection Fund.

CONCLUSION

- 6.99 When making investment decisions, trustees are subject to a variety of duties. They should start from the trust deed: what is the purpose of the investment power? In a pension trust, investment powers are granted to trustees so that they can earn returns to provide a pension. In doing so, trustees must comply with the Investment Regulations and act with reasonable care and skill. The courts will respect trustees' discretion, provided they reach their decision in the right way. The duty to act in the best interests of the beneficiaries is best seen as shorthand for these duties.
- 6.100 The primary concern of trustees must be to generate risk-adjusted returns. In doing so, they should take into account factors which are financially material to the performance of an investment. These may include environmental, social and governance factors. It is for trustees, acting on proper advice, to evaluate and weigh these risks.
- 6.101 However, the law is flexible enough to accommodate other concerns. Trustees may take account of non-financial factors if they have a good reason to think that the scheme members share a particular view, and their decision does not risk significant financial detriment to the fund.
- 6.102 There are some limited circumstances in which significant financial detriment to the fund may be justified. Trustees must act in accordance with the trust instrument, and this may contain provisions affecting trustees' investment discretion. Moreover, where members of DC schemes choose to invest on an ethical basis, there can be no legal objection if the performance of their investments is less than would otherwise have been the case. Trustees may also be provided with greater discretion when dealing with an employer and staff who share a strong political or ethical concern (an "affinity group").

CHAPTER 7

FACTORS IN PENSION TRUST INVESTMENT: A NEED FOR REFORM?

- 7.1 In the previous Chapter we explained how far the current law permits pension trustees to consider financial factors and non-financial factors in reaching investment decisions. Here we consider whether the law set out in Chapter 6 comes to the right answer in policy terms.
- 7.2 Our terms of reference ask us to consider whether the legal duties of pension trustees are conducive to investment strategies in the best interests of the ultimate beneficiaries. In particular, do they reflect an appropriate understanding of beneficiaries' best interests, encourage long-term investment, and allow ethical standards to be taken into account? If not, we are asked to make recommendations for change.
- 7.3 A majority of consultees thought that the current law was broadly correct in substance. However, many people criticised it for its uncertainty. It was said that trustees were often baffled by its complexity: they were unsure of the procedural steps they needed to take to comply with their duties and this made them risk-averse. As a result, trustees may not do enough to take account of environmental, social and governance factors or to engage with their beneficiaries. Although there were many other factors leading to short-term investment decisions, this confusion was thought to exacerbate the problem.
- 7.4 In this Chapter we reach the conclusion that the law in this area does not need substantive change. However, it is complex, difficult to find and not well known. This may lead trustees to be overly narrow in their approach to investment factors and to their beneficiaries' concerns. We consider ways in which this confusion may be addressed.

AN APPROPRIATE UNDERSTANDING OF BENEFICIARIES' INTERESTS?

- 7.5 Our view is that the scope of beneficiaries' best interests depends on the purpose of the trust. Where the purpose of a trust is to provide a pension, trustees will generally act in their beneficiaries' best interests by exercising their investment power to generate the best realistic return over the long term, given the need to control for risks.
- 7.6 In the Consultation Paper, we asked consultees whether this reflected an appropriate understanding of beneficiaries' best interests. A majority of consultees thought that it did.¹

¹ Out of 59 responses, 37 (63%) said yes, 10 (17%) said no and 12 (20%) gave other responses.

A focus on financial returns, subject to flexibility

- 7.7 Those consultees who agreed thought it was right that trustees should use their powers to further the purpose of the trust. USS Investment Management said that this analysis corresponded with legal advice they had received:

USS remains a trust for the provision of financial benefits on retirement and otherwise on the termination of pensionable service. The investment powers of the Trustee Company must accordingly be exercised so as to fulfil the objective of having an investment policy which is designed to generate sufficient expected returns within the risk tolerance of the sponsors so as to enable those financial benefits to be provided, together with the contributions made by the institutions and the members of the scheme.

- 7.8 Similarly, Turcan Connell noted that:

In taking decisions in relation to investment matters, trustees are obliged to fulfil the purposes for which they exist. In the case of pension trustees that is the provision of pensions.

- 7.9 Some consultees noted that whilst the pursuit of a financial return should be the predominant concern of pension trustees, the law was sufficiently flexible to allow other, subordinate, concerns to be taken into account. Wider considerations could be considered as long as they were in line with the purpose of the trust. As Capital Employee Benefits and Capital Trust Company Limited put it:

The law appropriately recognises the overall objective – the purpose for which trustees have their powers... Environmental, social and governance factors can influence financial returns and, to the extent they may do so, it is in beneficiaries' best interests for them to be taken into account.

- 7.10 The National Association of Pension Funds (NAPF) also noted this flexibility, observing that:

The interpretation of the law as set out within the consultation document rightly suggests that the law as currently understood is sufficiently permissive to enable trustees to use their judgement and discretion appropriately. This flexibility extends to consideration of environmental, social and governance (ESG) factors and to fulfilment of their stewardship responsibilities as set out within the UK Stewardship Code.

Arguments for a wider focus

- 7.11 Other consultees argued in favour of a broader interpretation. David Hunter told us that the presumption that delivering a financial return is necessarily in beneficiaries' best interests was "simplistic and misleading". His view was that:

The purpose of providing access to finance in retirement is to enable the beneficiary to live as comfortably as possible with the resources available.

- 7.12 The Association of Member Nominated Trustees also thought there was little use in focusing on financial returns without also looking at beneficiaries' quality of life:

What is the point of targeting pension benefits that are nominally higher but buy lower quality of life? To the extent that trustees' choice of investment (or indeed benefit design in so far as they can affect that) may consciously have the effect of trading off well-being against money, that would seem to sit ill with their proper purpose.

Beneficiaries' interests as long-term interests

- 7.13 A number of consultees thought that it should be made clear that beneficiaries' best financial interests are long-term. Royal London Asset Management were critical of the failure to recognise this, noting that:

It may be incorrect to assume reduced benefits to members in the short term will produce sub-optimal results overall. Arguably, it would be considered imprudent for a trustee to favour the interests of older beneficiaries in short-term over those beneficiaries not expected to retire for another 20 or 30 years, or vice-versa. ... trustees must balance the long-term needs of future beneficiaries with the more imminent obligation to current pensioners – one should not jeopardise the other.

- 7.14 A similar view was taken by Legal & General Investment Management, who commented that:

Beneficiaries' interests span well into the future, therefore it is critical that asset owners do not place too heavy an emphasis on the interests of today's retirees at the expense of tomorrow's. Asset owners, advisors and asset managers should be mandated to look at long term horizons, in order to align the interests of all beneficiaries.

- 7.15 Closely linked to this was the concern of many consultees about the lack of "intergenerational equity" in the current system. In particular, the Intergenerational Foundation urged us to examine whether trustees' investment strategies were systematically disadvantaging younger beneficiaries. They noted that:

Under the current laws, trustees are supposed to act impartially towards all their beneficiaries, yet in practice the focus which many trusts place on achieving the highest possible returns in the short-term effectively discriminates in favour of their older beneficiaries, who receive the higher returns in the form of pensions, while possibly endangering the money invested by their younger beneficiaries if such investment strategies involve greater risk.

The Intergenerational Foundation added that, given that pension trusts were essentially perpetual, trustees should have responsibilities to future beneficiaries as well.

Our conclusion

- 7.16 In Chapter 6 we said that, in the case of a pension scheme, the primary purpose is to earn returns to provide members with retirement and other benefits. We believe the law is right to focus on the need to generate returns. Schemes already suffer from low contribution levels and lacklustre investment performance: without a sustained focus on providing returns, the chances of success reduce further.
- 7.17 It is important that trustees adopt an appropriate time-frame over which they formulate their investment strategies. Investment strategies which aim to produce higher returns in the short-term but may endanger the financial viability of the scheme in the long-term will have a disproportionate impact on younger members. What is appropriate will vary from scheme to scheme. A very mature scheme, closed to new entrants and where the youngest members are close to retirement, may well choose to favour investments in fixed-income securities as opposed to equities. Whilst the appropriate strategy is matter for trustees' discretion, they should take care to comply with the duty of impartiality and even-handedness.
- 7.18 However, whilst generating financial returns should be trustees' predominant concern, we do not think that the law requires it to be trustee's sole concern. As we have explained, trustees may take into account "quality of life" factors, provided they remain a subordinate concern, and are subject to the tests we have outlined.
- 7.19 We have reached the conclusion that the law does not require substantive change. As we explore below, the main problem is that it is complex, inaccessible and poorly understood.

IS THE LAW SUFFICIENTLY CERTAIN?

- 7.20 We asked consultees whether they thought that the law was sufficiently certain. Views were fairly evenly split on this point.²

The advantages of flexibility

- 7.21 Those who argued that the law was sufficiently certain pointed to the advantages in preserving flexibility. The following views were typical:

This is not a field which lends itself to absolute certainty, but the case law in my view contains more than adequate guidance for trustees as to their duties. The law cannot be expected to provide micro-directions in this field. [Patrick Ford]

The existing flexibility is desirable as it enables trustees to adapt investment strategies to changing market conditions. [Association of Corporate Trustees]

² Out of 63 responses, 28 (44%) thought that the law was sufficiently certain, 26 (41%) thought that it was not and 9 (14%) gave other responses.

Trust law is based on equitable principles which by their nature are fluid and based on a sense of what is right under the circumstances. This approach is the right approach for this subject, and what it lacks in certainty it makes up for in adaptability. [NAPF]

- 7.22 The Association of Pension Lawyers expressed concern that further legislation would fail to adapt to changing circumstances:

Every scheme is different and trustees need to have a wide investment discretion if they are to maximise their ability to invest in the best interests of beneficiaries. The risk of legislation being too prescriptive is that it cannot adapt to changing circumstances, particularly in the investment arena where new developments occur frequently.

The problems of uncertainty

- 7.23 Other consultees thought that the uncertainty in the law caused confusion in practice and led trustees to be overly cautious in their approach. As the Institute of Business Ethics put it:

Flexibility may have some value in permitting a diverse choice of investment strategies but it is inevitable that it will also lead to confusion among practitioners. The question is how this problem should be addressed.

- 7.24 The Carbon Disclosure Project pointed to the “fragmentation and complexity of rules, practices, scheme etc. that need to be understood by those exercising fiduciary duty”.

The best interests of beneficiaries are not sufficiently well defined so it is difficult to know what tests to apply to determine satisfactory discharge of fiduciary duty.

- 7.25 There was a strong feeling that this was not simply an academic problem. The uncertainty and complexity of the law leads trustees to be risk averse, relying heavily on legal advice. It was said that trustees’ lawyers often took a narrow and cautious approach, suggesting than anything other than a focus on short-term profit introduced legal risk.

- 7.26 RPMI Railpen told us that they considered the law as it stood “fit for purpose” but that:

The law is sometimes interpreted in a highly conservative way that may discourage some actions which would be in beneficiaries’ interests. Some form of persuasive positive guidance from the Law Commission would be helpful in this respect.

- 7.27 Anna Tilba, ShareAction and EIRIS all referred to a “disconnect” between fiduciary duties as established in law and as applied in practice. Anna Tilba drew on her interviews with pension trustees to summarise their current understanding of trustees’ duties:³

Trustees understand their fiduciary duty primarily as the duty to act in the best *financial* interests of the pension fund members, i.e. the trustee role in relation to the trust is to deliver and pay benefits when they fall due to the members of the scheme. This predominant view was summarised by one trustee in the following way:

“Coming back to basics, a trustee has got to act in the members’ best interest – that’s just a principal trust law and that’s extended in the pensions law context to say that trustees have got to act in the members’ best financial interest... you’ve got to promise that the person will get his final salary on his retirement and that there is enough money there, because you promised to pay it.”

- 7.28 Consultees argued that this view was overly simplistic, but was often confirmed by the cautious advice lawyers tended to give to pension funds. This made trustees too reluctant to consider issues of long-term sustainability and too dismissive of their beneficiary’s views.

Failure to consider long-term sustainability

- 7.29 As Aviva Investors put it:

The law is sufficiently clear that trustees must invest in the best interests of the ultimate beneficiaries. At the present time the law does appear to place the obligation on trustees to factor in long-term considerations such as sustainability. However, for a myriad of reasons discussed in this response, the letter of the law is not being followed and the majority of trustees are giving insufficient attention to this highly pertinent topic.

- 7.30 Aviva Investors explained that it was common for institutional investors to default to an interpretation of their duties which requires them to focus solely on maximising profit for the beneficiaries in the short term. Furthermore, the agreements between investment managers and trustees often failed to address trustees’ duties in any meaningful way and added to the general level of confusion in this area.

- 7.31 Towers Watson also said that trustees felt they had to argue against a default view requiring short term profit:

Pension fund trustees often feel that the burden of proof is on them to make the case for sound long-term investments (eg sustainable investing); a burden of proof that they do not feel exists to the same extent when investing in the short-term.

³ See also A Tilba, *Stewardship and Fiduciary Duties: The Spectrum of Pension Fund Engagement* (2014). Available at http://eprint.ncl.ac.uk/pub_details2.aspx?pub_id=199078.

- 7.32 It was said that this was one small factor feeding into the problem of short-termism in financial factors. Anna Tilba explained that while there are “many factors which contribute to the short-termism of financial markets”, “the lack of clarity associated with ‘fiduciary duty’ seems to exacerbate the problem further”.

Failure to consider beneficiaries’ views

- 7.33 It was also argued that misunderstandings of the law led trustees to dismiss the views of their beneficiaries on the basis that trustees’ duties do not permit such considerations. ShareAction commented:

Our concern... is not that the fund should necessarily have supported the resolutions or acted on the beneficiary’s views. They might have sound reasons for not doing so, for example that they or their fund managers did not believe the issue in question to be material, or that they felt the costs of engaging on this issue would outweigh the benefits. However, responses which invoke fiduciary duty rarely set out any such reasons. Instead, they wrongly proclaim that the law prohibits them from even considering the matter at hand.

Our most recent comparable analysis suggests that this problem persists. In response to member emails asking about their position on climate change, 25% of funds referenced fiduciary duty – half as a reason to act on climate change, the other half as a reason to ignore it. In our view, there could scarcely be a better demonstration of the continuing confusion that surrounds this question

- 7.34 We were contacted by several members of the Universities Superannuation Scheme (USS) who made similar points. Susan Blackwell said:

I urge the Law Commission to recommend unambiguous clarification in statute that funds may take account of members’ ethical views. I cannot tell you how frustrated USS members like myself are at the scheme’s failure to address our ethical concerns and their persistence in investing our pensions in companies, sectors and countries which we find morally abhorrent.

Our conclusion

- 7.35 We accept that the law is confusing and inaccessible. It comes from several sources, including the trust deed, legislation, duties which attach to a power and duties of care, as well as “fiduciary duties” as understood by lawyers. Trustees are required to apply their minds to the right issues, and go through the decision in the right way, but there is no single point of reference to tell them how to do this.

- 7.36 As we explain below, we do not advocate legislation to codify the law, as we think that this could lead to unhelpful rigidity. However, we agree that further guidance should be available. Although we hope that this report will go some way to provide such guidance, we think that further material from The Pension Regulator would also assist. Finally, we consider the need to review the Occupational Pension Schemes (Investment) Regulations 2005.⁴

CODIFICATION

- 7.37 In the Consultation Paper we argued against attempting to codify the general law of fiduciary duties through legislation. We noted that fiduciary duties are difficult to define and inherently flexible. This was one of their essential characteristics: fiduciary duties form the background to other more definite duties, allowing the courts to intervene where the interests of justice require it. As a leading academic commentator puts it:

Equity's flexibility is important in ensuring that the law retains sufficient suppleness to cope with the social developments over which the court is asked to sit in judgment.⁵

Legislators should therefore resist the "siren call" of ever more formalistic tests.⁶ We provisionally concluded that any attempt to legislate for fiduciary duties could have unintended consequences and should not be pursued.

The arguments against statutory clarification

- 7.38 Most consultees agreed.⁷ The Association of Pension Lawyers said attempts at statutory reform "would be unhelpful". NEST Corporation warned that it would reduce the scope for the exercise of judgement currently offered by the law. The United Nations Principles for Responsible Investment Initiative (UNPRI) noted that:

We agree with the Law Commission that there would be inevitable and perhaps unhelpful complexities introduced were statute to be applied to an area of flexible common law.

- 7.39 BlackRock added:

We agree with the Law Commission's comment that fiduciary duties are difficult to define and inherently flexible, forming the background to other more definite duties. Consequently we do not see the benefit of statutory reform of the general law.

⁴ SI 2005 No 3378.

⁵ A Hudson, *Equity and Trusts* (7th ed 2012) p 7.

⁶ Above.

⁷ Out of 62 responses, 42 (68%) agreed that the general law of fiduciary duties should not be reformed by statute, 11 (18%) disagreed and 9 (15%) gave "other" responses.

The arguments in favour of statutory clarification

- 7.40 Those who argued in favour of statutory reform pointed out that case law is a slow and backward looking way to formulate the law. UKSIF said that trustees need guidance which is up to date and forward looking rather than guidance which is an “extrapolation from the past where that extrapolation is infused with the prudence of the legal profession”. Legal & General added:

We believe that we cannot rely on the courts to respond to the rapid developments in this field. As the Commission notes..., few cases are brought and the most vulnerable parties are those least able to mount legal challenges. As such, statutory clarification is arguably the most appropriate instrument, providing it is appropriately contextualised to allow for future adaptation.

- 7.41 Social Finance Ltd added:

We do not share the view that legislative clarification would make the law less flexible and suggest that uncertainty and narrow interpretations of the law have resulted in a perception of inflexibility which limits trustees’ ability to act. It is important to establish a clearly defined safe harbour for trustees.

Our conclusion

- 7.42 We think that statutory clarification would be a lengthy and laborious process, which could have unintended consequences. It may also prove difficult to keep up with the seismic shifts in the pensions landscape. Annuities are now only one of the retirement products available to savers; DB schemes are being replaced by DC schemes; and there is the potential for new “defined ambition” schemes to be introduced. Each of these changes alters the nature of the risk and therefore the considerations trustees need to consider.
- 7.43 We accept that trustees need more guidance but, as we explore below, we think that there are quicker and more effective ways to provide this.

THE NEED FOR GUIDANCE

This report

- 7.44 Several consultees thought that our report would be a useful first step. Social Finance said:

The Commission should ... as a minimum seek to clarify in its final report to fiduciary investors and market participants that the law allows ESG factors to be considered and taken into account in investment decisions, both in terms of excluding and including investments.

- 7.45 The NAPF suggested that a summary of our conclusions could be sent to trustees and investment intermediaries:

The Law Commission may wish to consider producing an open letter which could be sent to trustees and investment intermediaries summarising its key conclusions. This exercise may be most beneficial in terms of reaffirming that trustees can consider wider factors than short-term fund performance, including ESG issues, and that fulfilment of stewardship responsibilities is compatible, indeed arguably aligned, with a trustee's fiduciary duty

- 7.46 USS Investment Management made a similar suggestion:

The Law Commission (or another organisation such as the NAPF) may wish to consider producing authoritative advice to trustees summarising the key conclusions of the Law Commission's report (once it is finalised). This would be particularly useful in clarifying the position regarding trustees' fiduciary duties and the need for them to incorporate ESG considerations within their investment policy and its application, when material.

Guidance from The Pensions Regulator (TPR)

- 7.47 However, others thought that more was needed. Several argued that TPR should issue a code of practice on the issue. For example, Towers Watson said:

Our preference would be for the provision of statutory power to the Pensions Regulator to issue a Code of Practice on this matter. Such a code would reiterate the importance of investing in the best financial interests of the beneficiaries. However, it would also require trustees to have regard to current and future beneficiaries of the scheme, by being mindful of both short- and long-term investment opportunities.

- 7.48 NEST Corporation agreed:

We feel that the relevant department could issue a policy document clarifying the law and including worked examples – such as the Law Commission has produced for this consultation. We feel also that TPR could issue a similar document to trust-based pension providers.

- 7.49 Margarita Sweeney-Baird added:

A Code of Investment Principles applicable to the pension trustees and authorised persons within the pension investment chain is necessary. The regulator could take compliance with the Code into account in the assessment of the competence and skill and care of the authorised persons.

- 7.50 The Church of England National Investing Bodies' response pointed to the useful guidance on investment powers issued by the Charity Commission, and asked for similar guidance by TPR:

Our experience is that the greatest understanding of the flexibility of the law is found in the charity sector, largely thanks to the clarity of the Charity Commission's guidance on investment powers, CC14. Even in the Church of England, however, we come across small investing bodies (e.g. parishes) who have been advised by investment intermediaries and others against following ethical investment policies because 'the law of fiduciary duty does not permit it'.

Conclusion on the need for guidance

- 7.51 We hope that this report will go some way to explain the law, making it more accessible to trustees and their advisers. We would like stakeholders to circulate summaries of our conclusions to their members to increase the accessibility of the law.
- 7.52 However, we also think that it would be helpful if TPR were able to endorse these conclusions. There are two reasons for this. First, it will give greater prominence to the issue. This could be done either through regulatory guidance or through TPR's "trustee toolkit", which is an essential source of information and education for trustees. We think that guidance on this topic would be a particularly important way of removing confusion.
- 7.53 The second reason is to give these conclusions greater authority. TPR has a statutory power to issue codes of practice which have evidentiary value in legal proceedings.⁸ Section 90(5) of the Pensions Act 2004 states:

A code of practice issued under this section is admissible in evidence in any legal proceedings and, if any provision of such a code appears to the court or tribunal concerned to be relevant to any question arising in the proceedings, it must be taken into account in determining that question.

- 7.54 This means that if a case concerning trustees' investment duties reaches a court or the Pensions Ombudsman,⁹ and the code of practice appears to be relevant, it must be taken into account. This would strengthen the authority of the tests we have set out and ensure that they were considered in any subsequent court cases.

⁸ The statutory power is contained in section 90(1) of the Pensions Act 2004.

⁹ The definition of "legal proceedings" under the Pensions Act 2004 includes proceedings of the Pensions Ombudsman: Pensions Act 2004, section 90(6).

7.55 We see incorporating our tests into a code as supplementing TPR's existing work in this area. In November 2013, TPR published a code of practice outlining the legal requirements and standards of governance and administration that trustees of occupational DC trust-based schemes need to attain.¹⁰ The Code recognises that in a "quality scheme", the trustees will act in the best interests of all beneficiaries. The regulator's practical guidance is that:

When considering the suitability of investments, trustees should take into account environmental and social factors which may impact on longer term returns.¹¹

7.56 We think this statement could usefully be expanded along the lines set out in Chapter 6. However, we note that codes of practice take time to prepare and must be laid before Parliament.¹²

7.57 We recommend that TPR considers how the guidance we have set out can be given greater exposure and authority. In the short-term this could be through regulatory guidance or inclusion in its trustee toolkit. In the longer term, we recommend that TPR include our guidance in one of its codes of practice.

7.58 We have considered whether similar guidance needs to be made available to contract-based pension schemes, in their review of default fund strategy. In practice, the debate over the use of wider factors has focused on trust-based pensions, particularly DB schemes. However, as we note in Chapter 9, the Government is keen to ensure that the separate regulatory systems governing trust-based and contract-based schemes provide similar levels of protection. The Government therefore intends to introduce independent governance committees (IGCs) which will review whether contract-based schemes meet the same quality standards as those that govern trust-based schemes. In particular, IGCs will consider:

whether default investment strategies are designed in the interests of members, with a clear statement of aims, objective and structure and how these are appropriate for their membership.¹³

The FCA will be consulting on rules to implement this proposal.¹⁴

7.59 We recommend that in introducing this rule the Financial Conduct Authority consider whether IGCs need further guidance in interpreting the interests of members in default funds. We see no reason in principle why members' interests in contract-based default funds should differ from those in DC trust-based default funds.

¹⁰ The Pensions Regulator, *Code of practice no. 13: Governance and administration of occupational defined contribution trust-based schemes* (November 2013).

¹¹ Above, p 35.

¹² Pensions Act 2004, s 91(5)(a).

¹³ Better workplace pensions: Further measures for savers (2014) Cm 8840 p 18.

¹⁴ Above, p 7.

REVIEWING THE OCCUPATIONAL PENSION SCHEMES (INVESTMENT) REGULATIONS 2005

- 7.60 The Pensions Act 1995 provides occupational pension scheme trustees with a wide investment power. The main substance of how pension trustees should exercise this power is set out in the Occupational Pension Schemes (Investment) Regulations 2005, which we refer to as “the Investment Regulations”.¹⁵
- 7.61 The Investment Regulations make clear that pension trustees must invest prudently and in the best interests of beneficiaries, and explain in detail what “prudence” requires in practice. However, the Regulations do not apply to schemes with fewer than 100 members. In the Consultation Paper we asked if the Investment Regulations should be extended to all schemes.
- 7.62 Following consultation, we think that there are two aspects of the Investment Regulations which could usefully be reviewed. The first is whether smaller schemes should be included within regulation 4, which requires scheme assets to be invested “in the best interests of members and beneficiaries”. The second is the wording of regulation 2(3)(b)(vii) which requires a SIP to include a statement of the trustees’ policy on the extent to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments. Below we look at each in turn.

Extending regulation 4 to all schemes

- 7.63 Regulation 4 specifically states that assets must be invested “in the best interests of members and beneficiaries”.¹⁶ It then goes on to set out some important investment duties, including the requirements that:
- (1) the power of investment is exercised in a manner “calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole”;¹⁷
 - (2) assets held to cover the scheme’s technical provisions are invested in a manner “appropriate to the nature and duration of the expected future retirement benefits payable under the scheme”;¹⁸
 - (3) scheme assets consist predominantly of investments admitted to trading on regulated markets.¹⁹ Other investments must be kept at a prudent level;²⁰
 - (4) scheme assets must be properly diversified to “avoid excessive reliance on any particular asset, issuer or group of undertakings and so as to avoid accumulations of risk in the portfolio as a whole”;²¹ and

¹⁵ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 4.

¹⁶ Above, reg 4(2).

¹⁷ Above, reg 4(3).

¹⁸ Above, reg 4(4). A scheme’s “technical provisions” means the amount required, on an actuarial calculation, to make provision for the scheme’s liabilities: Pensions Act 2004, s 222(2).

¹⁹ Above, reg 4(5).

²⁰ Above, reg 4(6).

- (5) investment in derivative instruments may only be made in so far as they contribute to a reduction of risks or facilitate efficient portfolio management.²²
- 7.64 Regulation 4 implements article 18(1) of the IORP Directive. At the time the Government took the view that, whilst many of the requirements of article 18(1) were already reflected in existing domestic law, European law required that the Directive be implemented explicitly. The Explanatory Memorandum to the Investment Regulations notes:
- The combination of the domestic common law duties of prudence - often called the “prudent man of business test”, and the statutory requirements in the Pensions Act 1995 and the Financial Services and Markets Act 2000, may be said to ensure that investment decisions made by occupational pension schemes would be already compliant with Art.18(1). However, on the basis of ECJ rulings, legal advice is that, to ensure transparency, there need to be specific statutory “hooks” for implementing European Directives - reliance on common law is insufficient, and compliance with the Directive must be demonstrable in regulation.²³
- 7.65 We agree that regulation 4 reflects requirements pension trustees are already subject to under trust law. Our view is that the Investment Regulations provide a useful statement of what “prudence” requires in the case of pension trusts.
- 7.66 It therefore seems odd that regulation 7 of the Investment Regulations states that regulation 4 does not apply to schemes with fewer than 100 members. The reason for this exclusion is not based on any analysis of the case law. Instead, it reflects the discretion given to member states not to apply the IORP Directive to such schemes,²⁴ coupled with the Government’s apparent desire to impose no more regulation than is strictly necessary.²⁵

²¹ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 4(7).

²² Above, reg 4(8). Derivative instruments are defined as including any of the instruments listed in paragraphs (4) to (10) of Section C of Annex 1 to the Markets in Financial Instruments Directive 2004/39/EC, Official Journal L145 of 30.4.2004 p 1.

²³ Explanatory Memorandum to the Occupational Pension Schemes (Investment) Regulations, para 7.3.

²⁴ Institutions for Occupational Retirement Provision (IORP) Directive 2003/41/EC, Official Journal L 235 of 23.09.2003 p 10, art 5.

²⁵ Explanatory Memorandum to the Occupational Pension Schemes (Investment) Regulations, para 4.6. In the European Commission’s Impact Assessment for the draft IORP2 Directive, it is noted that the article 5 exemption for schemes with fewer than 100 members has been retained. Currently, only six member states have taken advantage of this exemption: Cyprus, Denmark, Ireland, Italy, Sweden and the UK. See <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52014SC0103> at para 3.4.2.

- 7.67 We think that the result is confusing. It may cause smaller schemes to think, wrongly, that they do not have to invest in the best interests of their members. It would also be unfortunate if smaller schemes felt that they did not need to hold investments which were appropriate to the duration of the expected future retirement benefits, or that their portfolios did not need to be properly diversified. It would be even more unfortunate if they thought that they should be investing excessively in derivatives or on unregulated markets.

Consultees' support for extending regulation 4

- 7.68 Only a few consultees fully engaged with this issue, but among those that did several agreed that it would be appropriate to extend the regulation to all schemes. The Association of Pension Lawyers stated:

In practice we would expect schemes that are currently excluded from the scope of regulations 4 and 5 to be subject to some of these requirements in any event as a matter of common law - for example, the requirements to invest assets in the best interests of members and beneficiaries. In the circumstances, it may be preferable in the interests of clarity to extend the regulations to cover all schemes.

- 7.69 Similarly, Capita Employee Benefits and Capita Trust Company Limited argued:

In our view, the requirements in regulation 4 of the Investment Regulations are appropriate for small schemes and are actually of even greater relevance currently given the massive increase in pension liberation activity.

- 7.70 Baker & McKenzie LLP agreed that there was a case for extending regulation 4 (though not regulation 2). UNPRI added that "we believe that it is hard to argue that the standards should not apply across the board".

Arguments against the change

- 7.71 Some of the arguments made against the extension appear to be based on a misunderstanding. Allen & Overy LLP observed that:

In our experience examples of surprising and arguably unjustifiable investment choices are more commonly seen in very small schemes (12 or fewer members) where trustees are perhaps less well-advised, investment decision-making is less transparent and the scheme is less closely regulated.

- 7.72 However, they went on to add that "the existing legal framework appears adequate to address the issues", and additional regulation would not necessarily change the position. We agree that the legal framework does already include these requirements. We do not think that removing the apparent exemption for small schemes would add new regulatory requirements. It would simply remove one source of confusion.

7.73 Aviva Life and Pensions commented that “many smaller trust based schemes are invested wholly in insurance contracts”. They expressed concern that regulation 4 is incompatible with this approach, as it seems to imply that schemes should hold a fully diversified portfolio. Again we think that this is based on a misunderstanding. The Investment Regulations treat qualifying insurance policies as an investment on a regulated market,²⁶ and regulation 4(10) provides that:

To the extent that the assets of a scheme consist of qualifying insurance policies, those policies shall be treated as satisfying the requirement for proper diversification when considering the diversification of assets as a whole

7.74 Regulation 4 does not require that a scheme should necessarily hold a portfolio of shares, but if it does it should be properly diversified. If the current exemptions are thought to be inadequate, they could be extended further.

7.75 Finally, consultees queried how the extension of regulation 4 would impact on “liability driven investment” (LDI). LDIs aim to match returns to the time frame over which the liabilities arise (say 20 years), so as to make the fund less vulnerable to interest rate and inflation risks. Typically, LDIs use swaps and other derivatives to hedge against the risk of changes in the economic climate that might affect the value of their investments in the medium or long term. The Pensions Policy Institute reports that LDI assets under management in the UK increased from £243 billion at the end of 2010 to £312 billion at the end of 2011, an increase of almost 30%.²⁷ These hedging arrangements can be highly complex and require specialist advice.

7.76 NAPF commented that regulation 4 militates against the use of derivatives, which may only be used “in so far as they contribute to a reduction of risks; or facilitate efficient portfolio management”. It seems right, however, that pension funds should only use derivatives if trustees fully understand the implications. If this warning is required for large funds, it is even more necessary for smaller funds.

Conclusion on regulation 4

7.77 We think that there is a strong case to review regulation 4 with a view to removing the current exemption for small schemes. This is not intended to add new regulations on small schemes. It simply clarifies the principles which already apply to them. A review may decide that certain exemptions should be preserved.²⁸

²⁶ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 4(9)(b).

²⁷ Pensions Policy Institute, *The changing landscape of pension schemes in the private sector in the UK* (June 2012) p 46.

²⁸ For example, an exemption for “micro schemes” (2-11 members). These schemes are not designed for the mass market and are essentially tax-wrappers for high net worth individuals.

7.78 We are not recommending that any of the other exemptions for small schemes in the Investment Regulations be removed. Consultees had particular concerns about the costs that would be imposed by removing the exemption for small schemes from having to prepare and maintain a statement of investment principles.²⁹ We believe the appropriate burden of costs is a matter for Government.

A policy on “social, environmental or ethical considerations”

7.79 The Pensions Act 1995 requires a statement of investment principles (SIP) to be prepared and maintained.³⁰ It must be reviewed at least every three years and the Investment Regulations prescribe the content of a SIP.³¹ Regulation 2(3)(b)(vii) requires a SIP to include a statement of the trustees’ policy on the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments.

7.80 Consultees explained that the reference to ethical factors alongside social and environmental factors is a major source of confusion for trustees because it leads to the conflation of ESG with ethics. NEST Corporation said:

We suspect that a lot of the confusion comes from the lack of understanding or clarity as to what ESG means and a conflation between ESG and ethical factors. This is not helped in our view by the requirement currently contained in the 2005 investment regulations, made under the Pensions Act 1995, encouraging trustees to determine what (if any) consideration trustees have given to social, environmental or ethical considerations. This SEE configuration is unhelpful in our view.

7.81 Some consultees therefore argued that the Investment Regulations are one area where there is uncertainty. In order to tackle this uncertainty the Association of British Insurers suggested that this part of Investment Regulations should be reviewed. They said:

We recommend a review to bring the disclosure content of this requirement up to date and in line with current market practices.

7.82 The NAPF suggested amending this part of the Investment Regulations in order to tackle the uncertainty. They said:

We think there is merit therefore in considering amending the SIP requirements to focus more on those activities in relation to ESG factors and stewardship, separating these activities from the discussion of ethical considerations.

²⁹ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 6.

³⁰ Pensions Act 1995, s 35(1).

³¹ Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, regs 2(1)(a), 2(3).

- 7.83 NEST Corporation considered that this change ought to be reflected by moving the consideration of ESG risks to a different section of the SIP. They noted that there is a requirement under regulation 2(3)(b)(iii) for the SIP to disclose the trustees' policy on risks, including the ways in which risks are measured and managed. This, it was said, might be a more appropriate place for the consideration of ESG risks.

Conclusion on regulation 2(3)(b)(vii)

- 7.84 We recommend that regulation 2(3)(b)(vii) should be amended to distinguish more clearly between financial and non-financial factors. We think it is right that trustees should state their policy on how they evaluate risks to a company's long-term sustainability (including risks relating to governance or to the firm's environment or social impact). Also, as a separate issue, we think that trustees should consider their policy on responding to beneficiaries ethical and other concerns.
- 7.85 NAPF also mention stewardship. As we discussed in Chapter 5, we think it would be helpful if there was a specific requirement that the SIP contain a statement of trustees' policy (if any) on stewardship. For example, trustees should disclose if they intend to engage with companies or exercise voting rights, either directly or through their investment managers, and how this will be undertaken.

Local Government Pension Scheme

- 7.86 As we noted in Chapter 4, consultees raised concerns about the failure to transpose article 18(1) of the IORP Directive into the regulations governing the Local Government Pension Scheme (LGPS). As a consequence, there is no legislative equivalent for the LGPS to the requirements imposed by regulation 4 of the Investment Regulations. In particular, there is no requirement in the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009³² for the scheme assets to be invested in "the best interests of members and beneficiaries".
- 7.87 Whilst it is unclear what effect this has in practice, given that the Directive may be directly applicable and that some administering authorities regard themselves as "quasi-trustees", we think this uncertainty is undesirable. It should be put beyond doubt that the requirements of article 18(1) of the IORP Directive apply to the LGPS.
- 7.88 In Chapter 4 we also commented on the criticisms made by Professor Kay of short-term appointments, coupled with quarterly reviews. It may therefore be helpful to review the requirements under regulation 9 that the administering authority must be able to terminate the appointment by not more than one month's notice,³³ and that the investment manager must report to the administering authority at least once every three months.³⁴

³² SI 2009 No 3093.

³³ Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 SI 2009 No 3093, reg 9(2).

³⁴ Above, reg 9(3).

THE WAY FORWARD

- 7.89 We remain of the view that there is no need for a substantive change in the law. Statutory codification of the law in this area would be a lengthy process and there is a danger of unintended consequences. We feel it is valuable to preserve the flexibility of the law to deal with developments in practice.
- 7.90 However, we share consultees' concerns about the uncertainty and inaccessibility of the law. We hope that this report and our conclusions will assist in dispelling this uncertainty. However, we think that it would be useful to have the regulator's endorsement for these conclusions. We therefore make the following recommendations.
- 7.91 **We recommend that TPR considers how the guidance we have set out can be given greater exposure and authority. In the short-term this could be through guidance in its trustee toolkit. In the longer term, we recommend that TPR include our guidance in one of its codes of practice.**
- 7.92 **We recommend that the Financial Conduct Authority consider whether IGCs need further guidance in interpreting the interests of members in default funds.**
- 7.93 We also make some limited recommendations concerning the Occupational Pension Scheme (Investment) Regulations 2005 and the Local Government Pension Scheme Regulations 2013, as set out below.
- 7.94 **We recommend that the Government should review three aspects of the Occupational Pension Schemes (Investment) Regulations 2005. These are**
- (1) **the exemption of schemes with fewer than 100 members from the provisions of regulation 4;**
 - (2) **the reference to "social, environmental or ethical considerations" in regulation 2(3)(b)(vii), to ensure that it accurately reflects the distinction between financial factors and non-financial factors; and**
 - (3) **whether trustees should be required to state their policy (if any) on stewardship.**
- 7.95 **We recommend that the Government should review two aspects of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009. These are:**
- (1) **whether the Regulations should transpose article 18(1) of the IORP Directive; and**
 - (2) **those aspects of regulation 9 which require investment managers to be appointed on a short-term basis and reviewed at least every three months.**

CHAPTER 8

CONTRACT-BASED PENSIONS: DUTIES TO ACT IN THE BEST INTERESTS OF MEMBERS

- 8.1 In this Chapter, we look at contract-based pension schemes. We ask how far providers of contract-based pensions are under a duty to act in the best interests of members.
- 8.2 As we saw in Chapter 2, private sector defined benefit (DB) schemes are trust-based.¹ However, workplace defined contribution (DC) schemes may either be set up under trust or under contract. Although both trust and contract-based DC workplace pensions serve the same function, they are governed by different systems of law and regulation. As discussed in Chapter 4, trust-based schemes are subject to trust law and the pensions legislation. By contrast, contract-based schemes are subject to contract law and Financial Conduct Authority (FCA) rules.
- 8.3 Here we provide a brief introduction to the legal framework governing workplace contract-based pensions. Although contract-based providers are not subject to the trust-based rules described in Chapters 3 and 4, the FCA rules require providers to act in the best interests of clients, providing similar protection in some areas.

A CONTRACT WITH EACH INDIVIDUAL MEMBER

- 8.4 Employers increasingly use group personal pensions to make pension provision for their employees. The employer chooses the scheme and may make arrangements to collect and pay contributions on behalf of members. However, in legal terms, the scheme is characterised as a contract between each employee and the pension provider. As one textbook notes:

From an employee relations point of view, the arrangements will have the appearance of being a scheme run by the employer, although legally this is a series of individual schemes taken out by each employee.²

- 8.5 The provider of a contract-based pension scheme will typically offer a range of funds in which a member may choose to invest. However, under auto-enrolment, the provider cannot compel a choice.³ All schemes must offer a default fund, to be used in the absence of member choice.

Unfair terms

- 8.6 The problem with contract terms is that they are written by the provider. It is extremely rare for scheme members to even read the full terms – and if they do, there is little they can do to alter them. Pension schemes, like other consumer financial products, are “adhesion contracts”, offered on a “take it or leave it” basis.

¹ See para 2.5 above.

² *Tolley's Pensions Law* (Issue 83, May 2014) para A3.21.

- 8.7 The Unfair Terms in Consumer Contracts Regulations 1999⁴ provide some protection against unfair terms. Following litigation on bank charges, there has been controversy over how far these regulations permit the courts to assess the fairness of unreasonably high charges.⁵ The courts have no jurisdiction to look at price terms (such as annual management charges) which are clearly presented to members. However, if a price term is not in plain and intelligible language, it may be assessed for fairness.
- 8.8 The Law Commission and Scottish Law Commission have recommended that the law should be clarified to state that the price terms are only exempt if they are transparent and prominent.⁶ This change is now included in the Consumer Rights Bill, introduced into Parliament in January 2014.⁷ This means that, following the reform, the courts will have power to assess the fairness of charges which are presented in such a way that an average consumer would not be aware of them.

REGULATION

- 8.9 Providers operate in a highly regulated environment, and are subject to oversight by the FCA. They are also subject to supervision by the Prudential Regulation Authority, which considers issues of financial safety and capital liquidity. In the Consultation Paper, we provided a detailed outline of the structure of FCA rules.⁸ Below we highlight some aspects of the rules which are similar to the duty on pension trustees to act in the best interests of their members.
- 8.10 The FCA Handbook implements several European directives. For our purposes the most important is the Markets in Financial Instruments Directive (MiFID).⁹ This directive is intended to harmonise the provision of investment services to achieve similar regulatory outcomes across member states. It works together with the MiFID Implementing Directive¹⁰ and the MiFID Regulation,¹¹ collectively known as the “Level 2” legislation. We are aware that a new directive, intended to repeal MiFID and replace it with an updated form (generally known as MiFID 2), is due to be published in the Official Journal of the European Union.

³ Pensions Act 2008, s 17(2)(b).

⁴ SI 1999 No 2083.

⁵ See *Office of Fair Trading v Abbey National plc* [2009] UKSC 6, discussed in detail in Law Commission and Scottish Law Commission, *Unfair Terms in Consumer Contracts: a new approach?*, Issues Paper (July 2012).

⁶ Law Commission and Scottish Law Commission, *Unfair Terms in Consumer Contracts: Advice to the Department for Business, Innovation and Skills* (March 2013).

⁷ Consumer Rights Bill 2013-14 (HC Bill 180), cl 64(2).

⁸ CP 215, Chapter 8. Readers are referred to this Chapter for a fuller account of the applicable FCA rules.

⁹ Markets in Financial Instruments Directive 2004/39/EC, Official Journal L145 of 30.4.2004 p 1 (MiFID).

¹⁰ Markets in Financial Instruments Implementing Directive 2006/73/EC, Official Journal L241 of 2.9.2006 p 26 (MiFID Level 2).

¹¹ Markets in Financial Instruments Directive Regulation 1287/2006/EC, Official Journal L241 of 2.9.2006 p 1.

Principles for business

8.11 FCA rules set out eleven general principles for all authorised persons.¹² Five principles are particularly relevant to the type of protection provided by duties under “judge-made” law:

- (1) A firm must conduct its business with due skill, care and diligence (Principle 2).
- (2) A firm must pay due regard to the interests of its customers and treat them fairly (Principle 6).
- (3) A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading (Principle 7).
- (4) A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client (Principle 8).
- (5) A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment (Principle 9).¹³

8.12 These principles govern all the regulated activities of contract-based pension providers, including the decisions they make as to how to invest member contributions. If the Principles are breached, the FCA may bring an enforcement action. However, individuals have no right of action under the Financial Services and Markets Act 2000 (FSMA) simply for breach of the Principles.¹⁴

Conduct of business rules (COBS)

Acting honestly, fairly and professionally

8.13 COBS provide more detail on how these principles should be applied. COBS 2.1.1R contains the regulatory equivalent of the “best interests” duty:

A firm must act honestly, fairly and professionally in accordance with the best interests of its client.

8.14 As we explained in the Consultation Paper, a private person who has suffered loss as a result of a breach of this rule may bring an action for breach of statutory duty under section 138D of FSMA.¹⁵ However, we are not aware that any claims have been successfully brought under COBS 2.1.1.

¹² “Authorised persons” are defined in s 31 of the Financial Services and Markets Act 2000, and include persons who have permission to carry on regulated activities under Part 4A of that Act.

¹³ FCA Handbook PRIN 2.1.1R.

¹⁴ FCA Handbook PRIN 3.4.4R. For a discussion of FCA enforcement, the remedies available to private persons under the Financial Services and Markets Act 2000, and consumer redress, see CP 215 paras 8.71 to 8.76 and Appendix B.

¹⁵ CP 215 paras 8.72 to 8.75.

- 8.15 There are restrictions on the extent to which duties and liabilities under the FCA Handbook may be excluded or limited. COBS 2.1.2R states that:

A firm must not, in any communication relating to designated investment business¹⁶ seek to:

- (1) exclude or restrict; or
- (2) rely on any exclusion or restriction of;

any duty or liability it may have to a client under the regulatory system.

- 8.16 Firms will also often owe duties under the general law. For example, providers will have duties to take reasonable care and skill in carrying out the services they have undertaken to provide under the terms of the contract with the member. FCA guidance is that, in order to comply with the “best interests” duty under COBS 2.1.1R, firms:

should not, in any communication to a retail client relating to designated investment business:

- (a) seek to exclude or restrict; or
- (b) rely on any exclusion or restriction of;

any duty or liability it may have to a client other than under the regulatory system, unless it is honest, fair and professional for it to do so.¹⁷

- 8.17 The above rules are in addition to provisions under the general law which govern the exclusion or limitation of liability, such as the Unfair Terms in Consumer Contracts Regulations 1999.¹⁸

Disclosure of costs and risks

- 8.18 Under COBS 2.2.1R, a provider must provide appropriate information in a comprehensible form to a client about:

- (1) the firm and its services;
- (2) designated investments and proposed investment strategies;
- (3) execution venues; and
- (4) costs and associated charges.

¹⁶ “Designated investment business” includes a number of the activities listed in Part 2 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 SI 2001 No 544. The full list is available here: <http://www.fshandbook.info/FS/glossary-html/handbook/Glossary/D?definition=G283>.

¹⁷ FCA Handbook COBS 2.1.3G(1).

¹⁸ SI 1999 No 2083. See FCA Handbook COBS 2.1.3G(2).

8.19 COBS 14.3.2R states that:

A firm must provide a client with a general description of the nature and risks of designated investments, taking into account, in particular, the client's categorisation as a retail client or a professional client.¹⁹

8.20 The purpose of such disclosure is so that a client is reasonably able to understand the nature and risks of the service and the specific type of investment that is being offered and, consequently, to take investment decisions on an informed basis.²⁰

Unit-linked funds

8.21 In regulatory terms, the contract between the member and the pension provider is often characterised as a long-term contract of insurance. These “policies” typically offer members the choice of investing in a range of unit-linked funds. The FCA estimates that £900 billion is invested in unit-linked funds, approximately 85% of which is pensions savings.²¹

8.22 Where members invest in unit-linked policies, contributions paid by the member are treated as “premiums” and are used to allocate units to the member in the funds of their choice.²² The provider owns the assets of each fund and makes the investment decisions for each fund in accordance with its investment objectives. The units held by members in these funds are simply “units of account”; they do not confer any proprietary rights.²³ Unit prices rise and fall to reflect changes in the value of the fund's underlying assets.

Investment: mandate compliance and appropriateness

8.23 The FCA requires that funds are managed in accordance with the investment mandate, objectives and the disclosures that are made to customers. Furthermore, the assets backing unit-linked policies must be appropriate for customers. Assets which may be used to determine the level of benefits payable in unit-linked policies are known as the “permitted links”.²⁴

¹⁹ This rule only applies in relation to the business and activities listed in COBS 14.3.1R. “Designated investments” include a security or a contractually-based investment.

²⁰ FCA Handbook COBS 2.2.1R.

²¹ Financial Conduct Authority, *The governance of unit-linked funds* (October 2013) TR13/8, p 3.

²² Where the member has chosen more than one fund, their contributions will be split in accordance with their instructions.

²³ *Foskett v McKeown* [2001] 1 AC 102 at 143, by Lord Millett.

²⁴ See FCA Handbook COBS 21.

8.24 The Association of British Insurers (ABI) has produced a “Guide of good practice for unit-linked funds” which builds on these requirements. Firms should ensure they have sufficient information about the assets which their funds are invested in to ensure they meet customer expectations. In particular, the asset description provided to the customer should be consistent with that provided to the investment manager. The ABI’s Guide states that:

Firms should be mindful of their target market and ensure that they conduct sufficient analysis to enable them to make informed decisions about whether assets are appropriate as permitted links.²⁵

8.25 In addition to the rules on “permitted links”, there are also “close matching rules”. These rules provide that insurance companies must cover their liabilities with, as closely as possible, the assets to which those liabilities are linked.²⁶

Exercising discretion

8.26 Providers will often have discretion in relation to the management of funds. This may include the introduction of new charges. Whilst often the exercise of discretion will be subject to the terms and conditions of the contract between the client and the provider, these may not offer clients adequate protection.

8.27 Where providers have discretion, it is important that they treat customers fairly.²⁷ The ABI Guide notes that:

Where possible ... funds should be operated according to published criteria and standards. Specifically, the scope of the firm’s discretion in managing the fund and the limits to that discretion should be documented and disclosed to policyholders and other relevant parties, where appropriate.²⁸

²⁵ Association of British Insurers, *Guide to Good Practice for Unit-Linked Funds* (May 2014) para 4.21.

²⁶ FCA Handbook INSPRU 3.1.57R. Alternatively, the insurer may cover its liabilities with a property-linked reinsurance contract, or a combination of both assets and reinsurance contracts.

²⁷ The FCA Handbook makes this point explicitly in relation to “with-profits” policies, another type of policy used in long-term insurance business. Under these policies, the investor is promised a certain amount of pension in return for contributions, and in addition may be able to participate in the fund’s profits where the fund is, on an actuarial valuation, in surplus. COBS 20.2.3 provides that a firm must have good reason to believe that its payouts on individual with-profits policies are fair.

²⁸ Association of British Insurers, *Guide to Good Practice for Unit-Linked Funds* (May 2014) para 4.8.

Suitability

- 8.28 A firm must “take reasonable steps to ensure that a personal recommendation, or a decision to trade, is suitable for its client”.²⁹ In order for a firm to make a suitable recommendation or trading decision for its client, it must obtain the necessary information regarding the client’s:
- (1) knowledge and experience in the investment field relevant to the specific type of designated investment or service;
 - (2) financial situation; and
 - (3) investment objectives.
- 8.29 In the Consultation Paper, we took the view that pension providers would be subject to the suitability rules under COBS 9.³⁰ On revisiting the issue, we think this may not be the case. The rules in COBS 9 apply only to firms which make personal recommendations in relation to designated investments,³¹ or that manage investments.³² Contract-based pension schemes typically own the assets of the scheme themselves, and so will not fall within the regulatory definition of “managing investments” which requires that the assets belong “to another”.³³
- 8.30 However, independent financial advisers (IFAs) are under suitability requirements if they recommend contract-based schemes to clients. In the Consultation Paper we discussed a series of cases in which IFAs had been found liable for mis-selling pension schemes, in breach of suitability rules.³⁴ We noted that the courts tended to interpret an adviser’s duty of care in line with the regulator’s suitability rules.

²⁹ FCA Handbook COBS 9.2.1R. COBS 9 is not applicable to “execution only” type business (that is, business which does not involve the provision of advice or the exercise of discretion over investments belonging to others). All firms which provide “investment services” in the course of MiFID business which are not subject to COBS 9 are nonetheless subject to “appropriateness” requirements in COBS 10: FCA Handbook COBS 10.1.1R.

³⁰ CP 215 para 12.19.

³¹ FCA Handbook COBS 9.1.1R.

³² FCA Handbook COBS 9.1.3R.

³³ Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 SI 2001 No 544 art 37.

³⁴ See *Loosemore v Financial Concepts* [2001] Lloyd’s Rep PN 235 and *Gorham v British Telecommunications plc* [2000] 1 WLR 2129, discussed at CP 215 paras 11.65 to 11.68.

The emphasis on point of sale

- 8.31 The emphasis of the FCA Handbook is on ensuring that clients are fully aware of the costs and risks of products at the point of sale.³⁵ Under COBS 14.2.1R, a firm that sells a personal or stakeholder pension scheme to a retail client must provide a key features document and a key features illustration. According to the rules, a key features document:

must include enough information about the nature and complexity of the product, how it works, any limitations or minimum standards that apply and the material benefits and risks of buying or investing for a retail client to be able to make an informed decision about whether to proceed.³⁶

The document must explain the arrangements for handling complaints about the product, the availability of any compensation under the Financial Services Compensation Scheme, and details of any rights to cancel or withdraw.³⁷

- 8.32 Consultees emphasised to us that the requirements under FCA rules are concerned with “point of sale”, rather than ongoing suitability over time. Towers Watson put the point as follows:

The FCA regulates these DC providers and its oversight is intended to ensure that sales of financial products occur with the consumer having a full understanding of the product at the point of sale.

- 8.33 Towers Watson explained that under auto-enrolment, there was no “point of sale” at which the consumer can be demonstrated to have understood the terms and conditions of the product. They noted that because of the uncertain nature of pension outcomes, a static product which satisfies “point of sale” tests would either be too complex to explain or too simple to be effective.

- 8.34 The National Association of Pension Funds shared these concerns:

While an approach centred on point-of-sale might make a lot of sense for many retail products where the product is either simple or can be changed annually, pension savings products need to be looked at differently.

³⁵ This is in addition to the disclosure required by the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 SI 2013 No 2734.

³⁶ FCA Handbook COBS 13.3.1R(1).

³⁷ FCA Handbook COBS 13.3.1R(2).

Emphasis on product design rather than individual suitability

- 8.35 In the Consultation Paper we commented that there appeared to be no clear rule requiring providers to review the suitability of a scheme over time.³⁸ In so far as the FCA does recognise a duty to review products, the emphasis is on the overall suitability of the product for its target market, rather than its suitability for an individual member. For example, a product designed and marketed as a default fund should remain suitable as a default fund. The FCA has produced guidance on post-sale responsibility that states that firms:

should periodically review products whose performance may vary materially to check whether the product is continuing to meet the general needs of the target audience that it was designed for, or whether the product's performance will be significantly different from what the provider originally expected and communicated to the distributor or customer at the time of the sale If this occurs, the provider should consider what action to take, such as whether and how to inform the customer of this (to the extent the customer could not reasonably have been aware) and of their option to seek advice, and whether to cease selling the product.³⁹

Default funds

- 8.36 For default funds in auto-enrolment schemes, the Department of Work and Pensions (DWP) has published guidance which states that:

The design, performance and continued suitability of the default option and its investment strategy should undergo a full review by the designated party at least every three years.⁴⁰

DWP state that the review should look at governance arrangements and objectives; the suitability of the charge level; the investment strategy of the option; the performance of individual fund components; and whether the performance of individual components is consistent with the overall objective of the default option.⁴¹ However, this guidance does not have regulatory force.

³⁸ CP 215 para 12.20. COBS 9.2.5R states that a firm is entitled to rely on the information provided by its clients "unless it is aware that the information is manifestly out of date, inaccurate or incomplete". Respondents commented that this did not require pension providers to contact members to ask about changes in circumstances.

³⁹ Financial Conduct Authority, *The Responsibilities of Providers and Distributors for the Fair Treatment of Customers (RPPD)* (April 2013) para 1.21. The FCA stresses that this is only guidance, and that it need not be followed in order to achieve compliance with rules or other requirements. However, if a person acts in accordance with the guidance in the circumstances contemplated by the guidance, then the FCA will not take action against that person in relation to the aspects of the rules to which the guidance relates: see para 1.3.

⁴⁰ Department for Work and Pensions, *Guidance for offering a default option for defined contribution automatic enrolment pension schemes* (May 2011) para 23.

⁴¹ Above, para 26.

THE ROLE OF THE EMPLOYER

- 8.37 In a contract-based pension scheme, the employer chooses the scheme but has no ongoing responsibility for monitoring the performance of the scheme.⁴² Instead, the responsibility of the employer is often limited, where direct payment arrangements are in place,⁴³ to making direct contributions to the pension provider on behalf of the member.⁴⁴
- 8.38 It is arguable that employers may owe their current employees some obligations arising from the duty of mutual trust and confidence that exists between employers and employees. However, as the Investment Sub-Committee of the Association of Pension Lawyers noted in its written evidence to the Work and Pensions Select Committee:
- This duty is likely to be fairly limited, and would likely not extend, for example, to monitoring the suitability of investments in the contract-based scheme once the scheme had been established. Once an employee leaves active service the employer has no role whatsoever. Employers cannot require employees to move funds built up from past contributions, as to do so will border on advice, which the employer in most cases will not be qualified or authorised to give.⁴⁵
- 8.39 Where direct payment arrangements are in place, employers are under certain obligations to consult their employees about reductions in the employer's contributions or increases in the employees' contributions.⁴⁶ However, the relevant regulations do not apply to an employer in relation to a personal pension scheme where no employer contributions fall to be paid towards the scheme,⁴⁷ nor do they apply to an employer with fewer than 50 employees.⁴⁸

⁴² Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014) para 3.14.

⁴³ These are arrangements between the member and the employer under which contributions fall to be paid by the employer towards the scheme. Such arrangements will exist where the employer arranges to make employer contributions to a personal pension scheme and/or where the employer arranges to deduct the member's contributions from pay and to pay them across to the pension scheme for the member.

⁴⁴ Improving governance and best practice in workplace pensions, Sixth Report of the Select Committee on Work and Pensions (2012-13) HC 768-II at Ev 135.

⁴⁵ Improving governance and best practice in workplace pensions, Sixth Report of the Select Committee on Work and Pensions (2012-13) HC 768-III at Ev w5.

⁴⁶ Pensions Act 2004, s 260. The relevant regulations are the Occupational and Personal Pension Schemes (Consultation by Employers and Miscellaneous Amendment) Regulations SI 2006 No 349.

⁴⁷ Occupational and Personal Pension Schemes (Consultation by Employers and Miscellaneous Amendment) Regulations SI 2006 No 349, reg 5.

⁴⁸ Above, reg 3(2A)(c).

Voluntary governance arrangements

- 8.40 Some employers who offer personal pension schemes to their workers have chosen to put additional voluntary governance arrangements in place. In July 2013, The Pensions Regulator (TPR) published guidance for those employers that wished to establish “management committees” as a way of monitoring their schemes.⁴⁹ TPR recommended that any committee should focus on key areas. These include monitoring costs and charges and reviewing the default fund. TPR comments that where members have actively chosen their investments, management committees should ensure that they are regularly informed how important it is to review the suitability of their investment choices.⁵⁰
- 8.41 Employer-level governance arrangements are now fairly common. Research carried out by TPR in 2008 found that approximately half of employers offering personal pensions have some form of governance arrangement over and above that legally required, ranging from ad hoc reviews of the scheme to formal management committees.⁵¹ However, as DWP has noted:

While such arrangements can work well, they will not be practical or economic for all employers, particularly small ones.⁵²

This view was echoed by the Confederation of British Industry in their evidence to the Work and Pensions Select Committee. EEF also noted that fear of legal action, lack of understanding about pensions, and potential cost implications held some smaller employers back from setting up governance committees.⁵³ As small employers are brought into auto-enrolment, more employers will be unable to provide this sort of monitoring.

⁴⁹ The Pensions Regulator, *Monitoring your pension scheme: Management committees for employers* (July 2013).

⁵⁰ Above, p 5.

⁵¹ Department for Work and Pensions, *Quality standards in workplace defined contribution pension schemes: Call for evidence* (July 2013) para 27.

⁵² Above, para 28.

⁵³ Improving governance and best practice in workplace pensions, Sixth Report of the Select Committee on Work and Pensions (2012-13) HC 768-I at para 26. EEF, formerly the Engineering Employers' Federation, is a manufacturers' organisation for UK manufacturing companies.

INDEPENDENT GOVERNANCE COMMITTEES

- 8.42 Employers' voluntary arrangements cannot necessarily fill the "governance gap" within contract-based schemes. A series of recent reports have identified a problem with the lack of a single identifiable entity with ongoing responsibility for considering whether contract-based schemes are run in members' interests.⁵⁴ DWP has noted that:

Without any body with this overall responsibility, including beyond the point of sale, it is not clear whether and how conflicts of interest are identified and addressed and who is ensuring that decisions are taken in the interest of members of the scheme.⁵⁵

- 8.43 In September 2013, the Office of Fair Trading (OFT) published a market study into DC workplace pensions.⁵⁶ The OFT noted that contract-based providers "do not have a recognised equivalent of the trustee board that is ultimately accountable for representing the needs of scheme members".⁵⁷ Without strong governance, "providers may not have the incentive and ability to address high charges, poor administration, poor performance and outdated or unsuitable investment strategies".⁵⁸
- 8.44 Some providers, such as Legal & General, had already established governance committees. In response to the OFT's concerns, the ABI agreed to embed Independent Governance Committees (IGCs) within all providers of contract-based pension schemes.⁵⁹
- 8.45 In March 2014 the Government announced that, from April 2015, all providers of contract-based pensions will be required to operate IGCs to assess the value for money delivered by these schemes and report on how they meet quality standards.⁶⁰ We examine this in more detail in Chapter 9, looking at the Government's package of reform and the way in which IGCs will be embedded in the system. We also outline some of the challenges they face.

⁵⁴ See, for example, Improving governance and best practice in workplace pensions, Sixth Report of the Select Committee on Work and Pensions (2012-13) HC 768-I; Better workplace pensions: Further measures for savers (2014) Cm 8840 p 17.

⁵⁵ Department for Work and Pensions, *Quality standards in workplace defined contribution pension schemes: Call for evidence* (July 2013) para 25.

⁵⁶ Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014).

⁵⁷ Above, para 7.33.

⁵⁸ Above, para 7.34.

⁵⁹ Above, para 7.52.

⁶⁰ Better workplace pensions: Further measures for savers (2014) Cm 8840, p 10.

DO FIDUCIARY DUTIES APPLY TO CONTRACT-BASED PENSIONS?

8.46 In the Consultation Paper, we noted that in discussions stakeholders had consistently said that while trustees were subject to fiduciary duties, contract-based pension providers were not. We commented that, in our view, this was an over-simplification. Two consultation responses expressly agreed with this statement. The Law Society of Scotland noted:

We would agree that it is an over-simplification that contract-based providers are not subject to fiduciary duties. ... There are many decisions by the Pensions Ombudsman in relation to the discretionary distribution of death benefits that would support that contention.

8.47 Similarly, Dr Magdalena Raczynska and Professor Duncan Sheehan noted that:

We find it hard to understand why some stakeholders would say that fiduciary duties would not extend to contract-based pension providers. Those providers are still taking money from the investor in order to produce a return for them and the investor is in their hands as to whether and how that is accomplished.

Complex duties

8.48 We believe the position is more complex. Whilst, like trustees, contract-based pension providers are in a position to affect the interests of vulnerable members, this may be insufficient to ground a fiduciary duty in itself. As noted in Chapter 3,⁶¹ the courts have adopted a variety of approaches in determining whether a fiduciary relationship arises on the facts of a case. We think a court is likely to look at whether a member has a *legitimate* expectation that the provider will act in the member's interests. In many cases, the contract terms will mean that such an expectation will not be legitimate, even if it arises at all.

8.49 However, whilst they may not owe fiduciary duties, contract-based pension providers will owe other, "fiduciary-like" duties. As we have seen, COBS 2.1.1R requires firms "to act honestly, fairly and professionally in accordance with the best interests of its client". Where a private person has suffered loss through a breach of this rule, they may bring an action under section 138D of the Financial Services and Markets Act 2000.⁶²

8.50 Furthermore, contract providers owe duties to take reasonable care and skill in carrying out the services they have undertaken to provide under the terms of the contract. Similarly, when the provider has a discretion, the exercise of that discretion is unlikely to be unfettered. In *Paterson Arran Ltd Group Personal Pension Scheme*,⁶³ the Deputy Pensions Ombudsman considered the basic principles that the administrator of a scheme must follow in coming to a decision regarding the discretionary distribution of a death benefit:

- (1) they must ask correct questions;

⁶¹ See paras 3.16 to 3.24 above.

⁶² CP 215 paras 8.72 to 8.75.

⁶³ Ref 80843/1 (27 April 2011).

- (2) they must direct themselves properly in law; in particular they must adopt a correct construction of the scheme rules;
- (3) they must take into account all relevant factors, but no irrelevant factors;
- (4) they must not arrive at a perverse decision, ie a decision to which no reasonable body could arrive.⁶⁴

The contract model and auto-enrolment

- 8.51 That said, there are serious problems with the law relating to contract-based pensions. The contract model assumes that savers are fully informed autonomous parties, able to make good judgements in the market place. Yet the evidence is that savers fail to engage with pensions. This has now become institutionalised by auto-enrolment, where people are placed in pension schemes by default, without any conscious agreement to the charges or contract terms.
- 8.52 As we explore in Chapter 9, this leads to a lack of effective controls on high costs and charges. Schemes are chosen by employers, who may lack both the incentive and the skill to form complex judgements over charges that are paid for by the members. In trust-based schemes trustees are expected to make informed decisions on behalf of their members. Until now, there is no equivalent person within the contract system with a clear duty to monitor charges and costs.
- 8.53 There is also a lack of a clear duty on providers to monitor ongoing suitability over time. For default funds this is partially addressed by DWP guidance, though until now this has not had regulatory force. The problem also applies to chosen funds: an individual may choose to invest in a relatively risky equities fund in their 20s or 30s, and then forget all about it. The scheme may not still be suitable for them several decades later as they approach retirement. Contract-based providers are not required to review member choices, and even if they do they may lack the power to change contract terms without members' express agreement. Such agreement may not be forthcoming.

⁶⁴ *Paterson Arran Ltd Group Personal Pension Scheme* Ref 80843/1 (27 April 2011) para 27. See also *Standard Life Pension* Ref 74745/1 (30 September 2009); *Scottish Equitable Personal Pension Scheme* Ref 73461/1 and 75033/1 (25 June 2009).

8.54 Finally we have considered how far the law outlined in Chapter 6 applies to contract-based pension schemes. How far are contract-based providers required to consider risks to the long-term sustainability of companies in which they invest? And how far may contract-based default funds apply generally prevailing ethical standards? In contract-based schemes, this is likely to be considered as part of a duty of care, rather than a more general duty to act in a beneficiary's best interests, and there is even less guidance than for trustees. Given that trust-based and contract-based default funds perform the same function, we think that the law should seek to achieve similar outcomes. Both regulators have said that they have similar expectations for scheme quality and member outcomes.⁶⁵ In Chapter 9 we note that DWP aims to ensure minimum standards across the DC workplace market.

CONSULTEES' VIEWS

8.55 In the Consultation Paper, we asked consultees whether the duties of contract-based pension providers to act in the interests of scheme members should be strengthened and clarified. A large majority agreed that they should: out of 44 consultees who answered this question, 33 (75%) said yes, 4 (9%) said no and 7 (16%) gave "other" responses.

Agreement

8.56 There was strong support for imposing further duties on the providers of contract-based schemes. Some suggested that the need was urgent:

The need to protect DC assets is urgent. Assets need to be protected now for the benefit of the saver whilst the concept of saving itself needs protection. [UKSIF]

This is an urgent need for DC schemes today. Beneficiaries' assets need to be protected today as does encouraging widespread public acceptance of the concept of saving for retirement. If the ideas of auto enrolment and DC are compromised by a governance scandal for example the consequences would be highly damaging to the industry and the willingness of the public to save adequately for their retirement. [First State Investments]

The current structure of contract-based schemes provides very little comfort to beneficiaries that their interests are being safeguarded. [Institute of Business Ethics]

8.57 A number of consultees pointed towards the imbalance between the duties in trust-based and contract-based pensions. The Association of Consulting Actuaries told us that they were supportive of change in this area as it would:

Ensure greater consistency of approach between contract-based and trust-based pension schemes, and improve the likelihood of contract-based schemes delivering high quality pensions.

⁶⁵ Financial Conduct Authority and The Pensions Regulator, *Guide to the regulation of workplace defined contribution pensions* (March 2014) p 2. See also Better workplace pensions: Further measures for savers (2014) Cm 8840, p 5.

8.58 Similarly, ShareAction were of the view that:

There is a serious imbalance between the duties on trust-based and contract-based pension providers which could undermine the success of auto-enrolment.

8.59 Legal & General Investment Management noted that the differential treatment of trust-based and contract-based schemes was “arbitrary”, and that the current framework for contract-based schemes impeded the ability of providers to act in the best long-term interests of contract members.

Disagreement

8.60 Several arguments were put against change. It was said that the problems were not sufficiently serious; that contract-based pensions were different from trust-based pensions, so it was inappropriate to impose fiduciary-like duties on them; or that there was a risk of creating an excessively complex regulatory regime.

8.61 However, the main argument was that the industry was already making appropriate changes and that IGCs should be allowed to bed-in. As the ABI said:

ABI members offering contract-based workplace pensions have already made major changes to improve outcomes for pension-savers – charges are falling, transparency is increasing, significant innovations have taken place to ensure investment strategies are suitable, and savers are receiving much greater support as they approach retirement.

8.62 The same view was put forward by Aviva Life & Pensions:

The actions already planned, i.e. the formation of Internal Governance Committees, along with clarification, should be sufficient to meet these needs.

8.63 Several consultees thought that policy-makers should wait to see whether these arrangements are sufficient before taking further action. For example, the Society of Pension Consultants thought we should wait until “the work triggered by OFT’s workplace pension market report has run its course”. Similarly Pinsent Masons LLP said:

We believe that the introduction of independent governance committees is a step in the right direction in this regard and we recommend waiting to assess whether any further measures are needed until sufficient time has passed to allow a proper assessment to be made of the effectiveness of these committees. Any additional measures could be costly for pension providers.

CONCLUSION

8.64 There is widespread concern that workplace DC pensions do not always operate in the best interests of savers. Although these problems apply to both trust-based and contract-based schemes, they are particularly acute in contract-based schemes which do not have an equivalent of the trustee board to represent the needs of scheme members.

- 8.65 The contract model assumes that savers are autonomous parties, able to make informed judgements in the market place. This is unsuited to a system in which savers fail to engage with pensions and are often placed in pensions schemes by default, without agreeing to the charges or the terms.
- 8.66 From April 2015, contract-based pension providers will be required to establish IGCs to assess the value for money delivered by these schemes and report on how they meet quality standards. We think that IGCs will be central to establishing a system which can be used with auto-enrolment, to provide value for money and investment strategies in the best interests of savers. It is vital that IGCs are made to work. In the next Chapter we discuss the structure of IGCs and the challenges they face.

CHAPTER 9

DEFINED CONTRIBUTION WORKPLACE PENSIONS: CHALLENGES OF GOVERNANCE

- 9.1 Our terms of reference ask us “to consider whether fiduciary duties, as established in law or as applied in practice, are conducive to investment strategies that are in the best interests of the ultimate beneficiaries”. In the Consultation Paper we highlighted particular problems in ensuring that defined contribution (DC) workplace pension schemes work in the best interests of their members.
- 9.2 As auto-enrolment is being extended to smaller employers, DC pensions have come under the spotlight. Many groups have produced reports into the governance and regulation of such schemes.¹ Notably, in September 2013 the Office of Fair Trading (OFT) published a detailed market study of DC workplace pensions.² It noted:
- All pension providers, advisers, and industry experts that we consulted ... told us that good governance is crucial to achieving good member outcomes.³
- 9.3 The essential problem is that most employees fail to engage with pensions, while employers have neither the capability nor the incentive to drive competition. The OFT concluded that “the buyer side of the DC workplace pensions market is one of the weakest” that they had analysed in recent years.⁴ This leads to a “governance gap”: charges lack transparency; there is little pressure to keep charges low; and there is insufficient review of investment strategies.
- 9.4 In theory, the trust structure provides an answer to the governance gap. Trustees are under various duties aimed at ensuring that they act in the best interests of the members. They are expected to negotiate for low charges and review their investment strategies on an ongoing basis. The OFT found that despite these clear legal duties there were often problems in practice. Although single employer trust-based schemes often carried out these tasks well, smaller schemes may lack the necessary expertise and support, while some master trusts (multi-employer schemes) lacked independence.

¹ Fabian Society, *Pensions at Work, that Work: Completing the unfinished pensions revolution* (May 2013); Improving governance and best practice in workplace pensions, Sixth Report of the Select Committee on Work and Pensions (2012-13) HC 768-I; The Pensions Regulator: Regulating defined contribution pension schemes, Report by the Comptroller and Auditor General (2012-13) HC 466; D Harrison, D Blake and K Dowd, *VfM: assessing value for money in defined contribution default funds* (January 2014) p 13. See also OECD, *Pensions Outlook* (June 2012).

² Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014).

³ Above, para 7.18.

⁴ Above, para 1.9.

- 9.5 In contract-based schemes, problems exist both in law and practice. As discussed in Chapter 8, contract-based providers are not under explicit legal duties to act in the best interests of savers, and other arrangements to protect savers have been purely voluntary. Contract-based schemes also suffer from a lack of a clear governance structure. Because responsibilities may be “spread across a complex and potentially-conflicted range of entities”,⁵ it is often unclear where ongoing responsibility for scheme performance and strategy lies.
- 9.6 In this Chapter we start by highlighting the main problems with governance in DC workplace pensions. We then examine the Government’s response to these problems and the challenges ahead.

THE GOVERNANCE GAP

- 9.7 Chapter 13 of the Consultation Paper summarised the many reports on this issue. Here we draw on that chapter to highlight the most pressing problems caused by high charges and lack of review.

High, complex charges

- 9.8 As we have seen, charges may have a huge effect on the amount a DC member receives in retirement. As a rule of thumb, a member in a scheme charging 1.5% of the fund each year will receive a pension which is 20% lower than a member in a scheme charging 0.5%.⁶
- 9.9 Many organisations have criticised the fee structure of DC pensions. The Pensions Institute highlighted high and complicated fee structures in contract-based pensions and found “disingenuous practices” in respect of charge and cost disclosure.⁷ The Fabian Society noted that some schemes “are excessively priced” and “absorb too high a share of the individual’s pension savings”.⁸ For a minority of cases they found that “as much as half of a person’s savings can be absorbed in costs and charges”.⁹
- 9.10 The OFT investigated the issue in depth, looking at both contract-based and bundled trust schemes. They comment that, before the introduction of stakeholder pensions in 2001, the industry levied a wide variety of charges: annual percentage charges were supplemented by initial charges, ongoing fixed charges, early surrender penalties and other one off charges. In 2001, the industry moved toward levying a single percentage charge, known as the Annual Management Charge (AMC). There is now more competition based on this visible AMC. The majority of the market now charges on this basis.

⁵ The Pensions Institute, *Caveat Venditor: The brave new world of auto-enrolment should be governed by the principle of seller not buyer beware* (October 2012) p 23.

⁶ D Harrison, D Blake and K Dowd, *VfM: assessing value for money in defined contribution default funds* (January 2014) p 13. See also OECD, *Pensions Outlook* (October 2012) p 175.

⁷ The Pensions Institute, *Caveat Venditor: The brave new world of auto-enrolment should be governed by the principle of seller not buyer beware* (October 2012) pp 9 and 17-19.

⁸ Fabian Society, *Pensions at Work, that Work: Completing the unfinished pensions revolution* (May 2013) p 6.

⁹ Above.

- 9.11 However, problems remain. Pre-2001 “legacy” schemes remain open to new members and continue to charge well over the odds.¹⁰ In post-2001 schemes, there is no consistent means of calculating AMCs across the industry.¹¹ AMCs typically exclude “transaction costs”, which are borne by the member in addition to the AMC and often include brokers’ commissions, bid-offer spreads and taxes.¹²
- 9.12 This lack of transparency means that even where employers and employees are alive to the issue, they may not be able to compare the true cost across schemes. In many cases, neither is alive to the issue, and high charges are simply accepted.

Problems of governance in trust-based schemes

- 9.13 In trust-based schemes, the trustees’ obligations include a consideration of charges and investment strategy. However, the OFT noted that in practice there were problems with trust-based schemes.

Small schemes

- 9.14 The OFT found that large, single employer trust-based schemes tended to deliver good governance. However, even here some trustee boards in hybrid schemes focused too heavily on the defined benefit (DB) scheme, to the detriment of the DC scheme.¹³
- 9.15 In small and medium sized single employer trusts, trustees often lacked the necessary expertise and support. Research by the Pensions Regulator (TPR) suggests that larger schemes are more likely to have frequent meetings of the trustee board, better information provision, more training support for trustees and greater awareness of regulatory guidance.¹⁴ By contrast, in smaller schemes, trustees may not be aware of the full extent of their duties. Worryingly, 52% of small schemes and 38% of medium schemes had failed to review their SIPs in the last three years, even though this was a legal obligation.¹⁵

¹⁰ The OFT calculates that 1.377 million members of legacy schemes will together pay an additional £1.9 billion in AMCs over the remaining lifetime of their pensions – as well as further amounts in additional charges: Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014) paras 6.45-6.46.

¹¹ Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014) para 6.21.

¹² Above, para 6.28.

¹³ Above, paras 7.24-7.25.

¹⁴ Reinventing workplace pensions (November 2012) Cm 8478 p 24, citing The Pensions Regulator, *Occupational pension scheme governance: A report on the 2012 (sixth) scheme governance survey* (May 2012)..

¹⁵ Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014) para 7.26.

Master trusts

- 9.16 Many new entrants to the pension market have been set up as “master trusts”. Master trusts are multi-employer trust-based pension schemes, which a pension provider manages under a single account. There is one legal trust and, therefore, one trustee board.¹⁶ Some, such as NEST, work on a not-for-profit basis, while others have been established by insurance companies.¹⁷
- 9.17 Where master trusts are linked to the provider, they may suffer from conflicts of interest. Trustees who are appointed and paid by the provider may lack the motivation to challenge the provider’s actions. Furthermore, in some cases, the trust deed may prevent trustees from changing the investment manager of underperforming funds.¹⁸
- 9.18 We do not think that trust law provides a full answer to these problems. The duties owed by master trust trustees will be read subject to the trust deed, the consent of beneficiaries and the regulatory framework.

Member investment choices

- 9.19 Schemes used for automatic enrolment must offer a fund into which members’ contributions are invested by default (a “default fund”). However, members are often offered a choice of funds and in some cases, they may be encouraged to make a choice. The Pensions Institute report criticised the drive towards member driven investment, arguing that members made potentially “ill-informed decisions that they do not revisit and which can cost three or more times the charge of the default fund”.¹⁹
- 9.20 The industry has introduced standards to discourage a level of fund choice which is “overwhelming or restrictive”.²⁰ For example, the Pension Quality Mark standard (wholly owned by the NAPF) states that, as part of an adequate governance arrangement, a scheme “must offer simple investment options so that scheme members do not have to choose between large numbers of funds unless they are willing to do so”.²¹

¹⁶ Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014) p 10.

¹⁷ Above, para 4.9.

¹⁸ Above, para 7.30.

¹⁹ The Pensions Institute, *Caveat Venditor: The brave new world of auto-enrolment should be governed by the principle of seller not buyer beware* (October 2012) p 22.

²⁰ Investment Governance Group, *Principles for investment governance of work-based DC pension schemes* (November 2010). The Investment Governance Group (IGG) is a joint industry and governance initiative, tasked with encouraging engagement with, and standards of, investment governance across various types of work-based pension scheme. It is chaired by the Pensions Regulator and is composed of stakeholders from across the pensions industry. The Principles are available at <http://www.thepensionsregulator.gov.uk/about-us/principles-igg-dc.aspx>.

²¹ Pension Quality Mark, *The Standards* (August 2013) p 9.

- 9.21 However, there continue to be particular problems with chosen funds. First, the charges may be much higher, consuming a disproportionate part of the members' savings. Secondly, as the OFT put it, "the performance of financial markets, the cost of pension provision and investment philosophies can all evolve significantly over time".²² Persons in their twenties or thirties may choose a relatively risky equities-based scheme and then fail to review it. Even if it is clearly unsuitable for some approaching retirement, the provider has no obligation to alert them, and no power to change their fund choice without their consent.

THE GOVERNMENT'S RESPONSE

Overview

- 9.22 In March 2014, the Department for Work and Pensions (DWP) announced a detailed package of reforms to address these issues. These include: new minimum governance standards for all schemes; a requirement that contract-based providers establish independent governance committees; and a cap, set at 0.75% of funds under management, on all member-borne charges and deductions (excluding transaction costs) which may be levied on the default funds of DC qualifying schemes. The Government also intends to ban some forms of charging: no qualifying scheme will be allowed to charge adviser commissions or increase the charges members pay when they stop contributing to a scheme.²³
- 9.23 The Government has rejected calls for a single regulator.²⁴ Instead, DWP's work aims to ensure that there are certain minimum standards across the DC workplace market. The Financial Conduct Authority (FCA) and TPR will work together to set out the same expectations for scheme quality.²⁵ As their joint guidance notes:
- The FCA expects pension providers to ensure that customers are treated fairly in the same way that The Pensions Regulator expects trustees to act in the best interests of their scheme members.²⁶
- 9.24 The Government has now proposed a set of overarching standards across all schemes.²⁷ All schemes must be governed by a body with a duty to act in members' interests and the majority of individuals – including the chair – of the governing body must be independent of the pension provider. The governing body must consider not only the charges and costs of the scheme but also the investment strategies of the default scheme and standards of administration.

²² Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014) para 7.18.

²³ These are known as "active member discounts".

²⁴ Improving governance and best practice in workplace pensions: Government Response to the Committee's Sixth Report of Session 2012-13, First Special Report of Session 2013-14 (2013-14) HC 485 p 8.

²⁵ Financial Conduct Authority and The Pensions Regulator, *Guide to the regulation of workplace defined contribution pensions* (March 2014) p 3.

²⁶ Above, p 2.

²⁷ Better workplace pensions: Further measures for savers (2014) Cm 8840 p 11.

- 9.25 Alongside these changes, members of the Association of British Insurers have agreed to carry out an audit of schemes which charged more than the equivalent of a 1% AMC, under the supervision of an Independent Project Board.

Governance in trust based schemes

The problems of small schemes

- 9.26 As we noted in Chapter 2,²⁸ the size of a pension scheme can have an influence on how effectively it is governed and how able it is to protect members' interests. TPR has observed that larger schemes with more than 1,000 members are more likely to be able to demonstrate the DC quality features that drive good member outcomes than small and medium sized schemes.²⁹ In its evidence to the Work and Pensions Select Committee, the National Association of Pension Funds said that:

We have a rather odd set-up or infrastructure, if you like, of pension provision in the UK. We have something like 46,000 separate trust-based defined contribution (DC) schemes and over 100,000 separate contract-based schemes in the UK. It is our belief, supported by a considerable body of evidence both from the UK and internationally, that those smaller schemes tend to have weaker governance arrangements, and also tend to offer less value for money.³⁰

- 9.27 The OFT report also raised concerns about the risk of potential governance failures in small trust-based schemes. The report found that trustees of such schemes may lack the necessary expertise and may not provide governance oversight on an ongoing basis.³¹ The report also noted TPR's findings that small and medium sized trust-based schemes are less likely to demonstrate TPR's quality features, and that such schemes should therefore not be used for auto-enrolment purposes.³²

²⁸ See paras 2.71 to 2.72 above.

²⁹ The Pensions Regulator, *Ensuring good governance and administration in work-based defined contribution pension schemes* (January 2013) p 19. See also The Pensions Regulator, *Trust-based pension scheme features research. A summary research report on the draft defined contribution (DC) features* (January 2013) p 4.

³⁰ Improving governance and best practice in workplace pensions, Sixth Report of the Select Committee on Work and Pensions (2012-13) HC 768-II at Ev 21.

³¹ Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014) para 7.26.

³² Above, para 7.27.

- 9.28 The Government has acknowledged that small trust-based schemes have particular problems: members “may be disadvantaged because of low levels of trustee engagement and competence meaning that they are unable to secure the lower charges which larger schemes are able to do”.³³ However, it has decided against legislative intervention to reduce the number of small schemes.³⁴ It notes that consolidation is already taking place. It also points out that there are already ways in which smaller employers can “access the benefits of scale”, such as by joining a large group personal pension or a master trust.³⁵
- 9.29 The Government has also stated that trustees should consider how to deliver good value for members, which should include considering whether the scheme is operating with the correct scale. Where this is not the case, trustees should consider options for merging or otherwise expanding the scheme, alongside the option to close the scheme and move members to a pre-existing one. They note that TPR is planning to provide trustees with guidance on scheme closure and winding up.³⁶

New governance regulations

- 9.30 Rather than taking direct steps to consolidate schemes, the Government intends to introduce new quality requirements on trust-based schemes. Regulations will prescribe the following duties of trustees:
- (1) Default investment strategies must be designed in the interests of members, with a clear statement of aims, objective and structure and how these are appropriate for their membership.
 - (2) The characteristics and net performance of default investment strategies must be regularly reviewed to ensure alignment with the interests of members, and action taken to make any necessary changes.
 - (3) Core scheme financial transactions must be processed promptly and accurately.
 - (4) Trustees must assess the levels of charges borne by scheme members.
 - (5) Trustees must assess the costs incurred through investment of pension assets.
 - (6) The trustee board must have, or have access to, all of the knowledge and competencies necessary to properly run the scheme.³⁷
- 9.31 The Government has said that it plans to support these regulatory requirements with guidance.³⁸

³³ Better workplace pensions: Further measures for savers (2014) Cm 8840 p 24.

³⁴ Above, p 39.

³⁵ Above, p 32.

³⁶ Above, p 38.

³⁷ Above, p 12.

³⁸ Above.

A comparison with Australia

- 9.32 In the Consultation Paper we noted that the Australian Government had encouraged a major consolidation of pension schemes. This has led to a much more consolidated industry. The average scheme size in the UK is 2,500 members whereas it is 26,000 in Australia.³⁹ As the chairman of the Australian Government's superannuation review, Jeremy Cooper, remarked:

Superannuation isn't a cottage industry, it is complex, it's a scale business and really the "Get big or get out" motto really is very appropriate for this market and we make no apology about our scale theme.⁴⁰

- 9.33 In Australia, the Government has imposed explicit duties on the trustees of "MySuper" products (which are a form of low-cost default fund). Every year, trustees must determine whether the financial interests of their beneficiaries are disadvantaged compared to the beneficiaries of MySuper products in other schemes due to insufficient scale in terms of members or assets.⁴¹
- 9.34 DWP has stated that its proposals will "re-emphasise" issues of scale and "lead to the chair of the governing body focusing on this issue".⁴² Given the widespread evidence of problems with small schemes, it may be helpful for the new regulations to be as explicit on the issue as the Australian requirements.

Master trusts

- 9.35 The OFT raised concerns about the independence and effectiveness of governance in master trusts linked to a single provider. There is a fear that master trusts may be unwilling or unable to challenge the service provider.
- 9.36 The Government proposes that master trusts should be subject to requirements regarding independence of membership in the same way as contract-based schemes. Master trust boards will be required to have at least seven trustees, the majority of whom, including the chair, must be independent of the master trusts' service providers.⁴³
- 9.37 Another concern is that master trusts may lack the ability to terminate the services of the scheme administrator or investment adviser and switch to a different supplier. DWP proposes that trust deeds and rules should not be allowed to constrain trustees in their choice of providers or require them to make particular investments.⁴⁴

³⁹ M Johnson, "Pension funds must scale up and think big" (19 February 2012) *Financial Times*.

⁴⁰ Interview with Lateline Business, Australian Broadcasting Corporation (5 July 2010), available at <http://www.abc.net.au/lateline/business/items/201007/s2945485.htm>.

⁴¹ Superannuation Industry (Supervision) Act 1993, s 29VN(b). For more details on the Australian pensions market, see CP 215, Appendix C.

⁴² Better workplace pensions: Further measures for savers (2014) Cm 8840 p 38.

⁴³ Above, p 14.

⁴⁴ Above, p 15.

Contract-based schemes: Independent Governance Committees (IGCs)

- 9.38 Following the Office of Fair Trading report, the Association of British Insurers (ABI) agreed to embed IGCs within all providers of contract-based schemes.⁴⁵ They will be required to act in members' interests, by scrutinising whether the schemes are providing value for money. Where a committee identifies a problem, it will report on proposed action to the pension provider's board. The board must then take the proposed action, or explain why it has not done so. Where the board fails to act to the committee's satisfaction, the committee may inform employers and employees, escalate the matter to the relevant regulator or make the matter public.⁴⁶
- 9.39 The new committees will have independent chairs and a majority of independent members – and the ABI has undertaken that they will have the expertise and resources needed to carry out their duties.⁴⁷
- 9.40 The Government has announced that these requirements will be set out in FCA rules, and the FCA is expected to consult on these later this year. IGCs will be required to focus on three areas:⁴⁸
- (1) Whether default investment strategies are designed in the interests of members and regularly reviewed;
 - (2) The levels of charges borne by scheme members and costs incurred through investment;
 - (3) Whether core scheme financial transactions are processed promptly and accurately.
- 9.41 It is expected that FCA rules will require a provider to consider and act on all recommendations received from IGCs unless there are reasonable barriers to doing so. Where there are reasonable barriers, the provider will need to explain to the IGC why it is not feasible to implement the recommendations.⁴⁹ The FCA consultation may also consider whether there should be an explicit rule requiring providers to provide evidence that they have given due consideration at an appropriate level of seniority to recommendations made by IGCs.⁵⁰

⁴⁵ Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014) para 7.52.

⁴⁶ Better workplace pensions: Further measures for savers (2014) Cm 8840, p 17.

⁴⁷ Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014) para 9.12.

⁴⁸ Better workplace pensions: Further measures for savers (2014) Cm 8840 p 18.

⁴⁹ Above, p 19.

⁵⁰ Above, p 20.

9.42 IGCs are not required to relate their work to existing FCA principles and rules. Rather, they are expected to consider and make recommendations on all aspects of the value for money delivered by a scheme.⁵¹ However, the Government has said that it considers it likely that a breach of one of its scheme quality standards may result in the provider also being in breach of the existing FCA Principles.⁵²

The charge cap on default funds

9.43 The Government has announced that from April 2015, a charge cap will apply to the default funds of DC qualifying schemes. These schemes will not be permitted to charge members more than 0.75% of funds under management.

9.44 The cap will not apply to all charges. In designing the charge cap, the Government has drawn a distinction between “member-borne deductions” and “transaction costs”. Member-borne deductions are those costs and charges relating to scheme and investment administration, and fall within the cap. Transaction costs, on the other hand, are defined as the variable costs associated with buying, holding and selling the underlying investment instrument.⁵³ This covers:

- (1) brokerage commission and fees;
- (2) soft commission services included in brokerage fees (such as research costs);
- (3) transaction taxes, such as stamp duty;
- (4) bid-offer spreads - not only to investments but also foreign exchange;
- (5) other charges embedded in the transaction price (such as payments incurred through financial derivative instruments);
- (6) entry fees, other initial charges and exit fees for investment in underlying funds;
- (7) deductions of expenses or fees from profits such that they are not shared equally with members (for example, in relation to stock lending, interest income, and foreign currency exchange).⁵⁴

⁵¹ Better workplace pensions: Further measures for savers (2014) Cm 8840 p 20.

⁵² Specifically, Principle 2 (“A firm must conduct its business with due skill, care and diligence); Principle 6 (“A firm must pay due regard to the interests of its customers and treat them fairly”); and Principle 8 (“A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client”).

⁵³ Better workplace pensions: Further measures for savers (2014) Cm 8840 pp 59-60.

⁵⁴ Above, p 60.

- 9.45 The decision to exclude transaction costs was made because restricting the ability of investment managers to trade could be disadvantageous to schemes and members. The OFT report had made a similar point, commenting that “their inclusion could potentially create incentives for investment managers to avoid carrying out transactions in order to keep costs down, even where this is contrary to the members’ interest”.⁵⁵
- 9.46 Under Government plans, regulations and FCA rules will be introduced to require full disclosure of both administration and transaction costs. Trustees and IGCs will then be given the difficult task of assessing whether they provide value for money.

COMMENT ON THESE CHANGES

- 9.47 There is much in this proposal to welcome. We are particularly pleased that, following proposals in our Consultation Paper, IGCs will be under an explicit duty to act in the interests of members, and that pension providers will be required to indemnify members against any liability they may incur.

IGCs: duties and indemnities

- 9.48 In the Consultation Paper, we made two proposals regarding IGCs. Our first proposal was that members of IGCs should be subject to explicit duties to act in the interests of scheme members. This received strong support.⁵⁶ As Charlton Frank put it:

What is the point of IGCs if there is not a requirement for their members to act in the interests of scheme members?

- 9.49 Next we tentatively proposed that pension providers should be required to indemnify the members of their committees for any liabilities they incur in the course of their duties, or it might be difficult to find individuals willing to carry out the task. We said that pension providers were best placed to control the quality of the committees’ work, as they would appoint and resource the committees. An indemnity would give pension providers a clear interest in ensuring that the committees carry out their tasks correctly.

⁵⁵ Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014) para 9.19.

⁵⁶ Out of 40 responses, 26 (65%) agreed that IGCs should be subject to such duties, 6 (15%) disagreed and 8 (20%) gave “other” responses.

9.50 The Government has now announced that it agrees with these proposals, noting:

In its consultation on fiduciary duties, the Law Commission expressed a tentative view that members of IGCs should be subject to clear duties to act in the interests of members. The Law Commission further recommended that providers should provide a full indemnity to the members of their Committees for any liabilities they incur. As well as helping to ensure people are not put off from sitting on IGCs, this would give providers a clear interest in ensuring that the Committees carry out their tasks correctly. We agree with these proposals.⁵⁷

9.51 The majority of those who responded to this question agreed that pension providers should be obliged to indemnify members of IGCs. Most thought that it would be difficult in practice to recruit members to the committees without providing such an indemnity. The National Association of Pension Funds told us that:

In order to attract and empower individuals to join and actively participate as members of IGCs an indemnity would appear to be a pre-requisite requirement.

9.52 Similarly, NEST Corporation said that:

We don't see how the proposed governance committees could function without providers indemnifying the members.

9.53 We therefore recommend that IGCs embedded within pension providers owe a statutory duty to scheme members to act, with reasonable care and skill, in members' interests. This duty should not be excludable by contract. If IGCs fail to act in the best interests of scheme members, this may expose them to actions for breach of statutory duty, and pension providers should be obliged to indemnify members of the IGC against this liability.

CHALLENGES AHEAD

9.54 As the Kay Review made clear, it is not enough to subject financial intermediaries to legal duties. Intermediaries need the expertise, support and powers to fulfil their duties. They also need to be embedded within a system in which the incentives on intermediaries are aligned with those of the end-investor.

9.55 The Government acknowledges that its current proposals are only the start of a process. In particular, it has promised to review the default fund charge cap in 2017, considering whether some or all of the transaction costs should be included within its scope, and whether the cap should be lowered.⁵⁸

⁵⁷ Better workplace pensions: Further measures for savers (2014) Cm 8840 p 18.

⁵⁸ Above, p 99.

- 9.56 The Government has also promised to return to the issue of funds which, over time, have become unsuitable for members because of their investment strategy. It comments that:

A number of stakeholders have commented on the different abilities of trust and contract-based schemes to make changes to members' investments. While trustees can change investments on an ongoing basis to reflect trustees' assessment of what will be in members' interests, contract-based providers may be restricted in doing so by the terms of members' contracts.⁵⁹

It will reconsider this issue following the audit of high cost and legacy schemes, which is intended to provide further information about how far contract-based providers are prevented from making changes in the members' interests by contract terms.

- 9.57 In its report, the OFT noted that its recommendations were aimed at addressing the "urgent challenge" posed by the risk of consumer detriment in the short to medium term. It went on to add that:

A longer term challenge remains ... We therefore consider it would be helpful for future policy and regulatory initiatives to be informed by longer term principles for how the DC workplace pension market should evolve.⁶⁰

- 9.58 There are many challenges ahead in ensuring that DC workplace pensions operate in the long-term interests of savers, delivering good outcomes to their members. Here we focus on two particular problems, where the Government is already committed to further review. These are: monitoring transaction costs; and making changes to members' choice of funds.

The problems in monitoring transaction costs

- 9.59 We welcome moves to reduce the charges paid by scheme members. However, many consultees feared that a charging system in which management charges were capped but transaction costs were uncapped would lead to a "water-bed effect". Pension providers would use the many flexibilities in the system to increase transaction costs to make up for lower management charges.

⁵⁹ Better workplace pensions: Further measures for savers (2014) Cm 8840 p 20.

⁶⁰ Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014) paras 9.34, 9.37.

9.60 There is a long list of transaction costs which pension funds may deduct from members' pension pots in addition to the 0.75% cap.⁶¹ They range from brokers' fees, through bid-offer spreads and foreign exchange costs, to the charges embedded within other investments. We welcome the promise of FCA rules to make this plethora of other costs more transparent,⁶² and we are pleased that trustees and IGCs will be specifically required to monitor them. However, these will be extremely difficult tasks. We anticipate that much of the time of trustees and IGCs will be taken up with trying to understand and track these various costs and in assessing their value for money.

The need to favour investing over trading

9.61 The Kay Review stressed that charging structures should encourage long-term investment over short-term trading. In its response to the Review, the Government set out the following principle:

Market incentives should enable and encourage companies, savers and intermediaries to adopt investment approaches which achieve long-term returns by supporting and challenging corporate decisions in pursuit of long-term value.⁶³

In its directions for Government and regulators, the Kay Review said that "regulatory practice should favour investing over trading, not the other way round".⁶⁴

9.62 The OFT view recommended that the single "framework" charge should not include investment transaction costs, as "their inclusion could potentially create incentives for investment managers to avoid carrying out transactions in order to keep costs down", even where trading is in members' interests.⁶⁵ In the Consultation Paper we noted that allowing transaction costs to be deducted from funds may lead to the opposite problem: it could create inappropriate incentives to trade, even where this was not in savers' interests.⁶⁶

⁶¹ See para 9.44 above.

⁶² The FCA has recently published the findings of its thematic review into the clarity of fund charges. See Financial Conduct Authority, *Clarity of fund charges* (May 2014) TR14/7.

⁶³ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The Government Response to the Kay Review* (November 2012) p 13.

⁶⁴ J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012) p 44; Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The Government Response to the Kay Review* (November 2012) p 15.

⁶⁵ Office of Fair Trading, *Defined contribution workplace pension market study* (2013) para 9.19.

⁶⁶ CP 215 para 13.36.

- 9.63 We commented that there were no ideal answers. The question is whether it is better to stay with the existing system (which may favour too many short-term trades) or to take steps to reduce incentives to trade (with the possibility that this may lead to too few trades). DWP noted “divergent views” on this issue:

On the one hand some argue that it would mitigate against the risk that additional charges could be hidden as a means of circumventing the cap. On the other, some argue that by capping trading costs you could prevent trades occurring that are in the interests of members.⁶⁷

Potential problems

- 9.64 Consultees told us that there were many ways in which pension providers might use transaction costs inappropriately as a way of increasing overall charges.
- 9.65 The first is through the use of in-house brokers or deal makers. At present, lack of transparency reduces competition to drive down broking fees. Where the investment manager and brokers exist within a single group, high broking fees may be used to subsidise low fund management fees. Large investment houses may also act as internal deal makers, buying and selling equities between their own funds, and charging a bid-offer spread for doing so. It would be unfortunate if the charge cap led providers to increase trading simply to increase these fees.
- 9.66 Even where providers use external brokers, there is the possibility of what have been called “kick-backs” from broker to fund manager, in return for higher fees. FCA rules attempt to prevent this. As we explained in the Consultation Paper,⁶⁸ COBS 2.3.1R states that a firm must not pay or accept any fee or commission, or provide or receive any non-monetary benefit, in relation to designated investment business carried on for a client other than in accordance with the rules. In particular, COBS 11.6 sets out a general ban on investment managers using dealing commissions that are in addition to the actual cost of executing its customers orders.⁶⁹ The ban is designed to limit the ability of investment managers passing management costs through to their customers’ funds.
- 9.67 However, FCA rules provide an exception to allow investment managers to pay higher commissions on behalf of a client where the goods and services obtained in return for the charges:
- (1) are directly related to the execution of trades on behalf of the managers’ customers; or
 - (2) amounts to the provision of substantive research.⁷⁰

⁶⁷ Better workplace pensions: a consultation on charging (October 2013) Cm 8737 p 33.

⁶⁸ CP 215 para 8.65.

⁶⁹ FCA Handbook COBS 11.6.3R(1).

⁷⁰ FCA Handbook COBS 11.6.3R(3)(c).

In either case, the investment manager must have reasonable grounds to be satisfied that the goods and services purchased will reasonably assist the investment manager in the provision of its services to its customers on whose behalf the orders are being executed and not impair their duty to act in the best interests of customers.⁷¹

An illustration: problems with the research exception

- 9.68 In November 2012, the Financial Services Authority (as it then was) reported that some investment managers were deeming certain goods to be “research” that clearly went beyond what was indicated by the rules.⁷² In particular, they noted that the practice of arranging access to corporate management (“corporate access”) did not amount to research and should not be paid for with dealing commission.⁷³
- 9.69 In May 2014, the FCA published new rules aimed at clarifying the research exception. The proposed rules and guidance changes emphasise that research must be of a “substantive” nature, and add “corporate access” to the list of examples of goods and services that are not exempt, and so cannot be paid for from dealing commission.⁷⁴
- 9.70 We hope that the new rules will address this specific abuse. We have used the problems over the misuse of the research exemption as an illustration of the types of problems which trustees and the IGCs will need to address in order to prevent the water-bed effect of the charges cap.

Transaction costs: the way forward

- 9.71 We welcome the Government’s proposals to make transaction costs more transparent and require them to be reviewed by trustees and IGCs. However, one should not under-estimate the complexities and difficulties of the task ahead. It is important that trustees and IGC members are given training and support on this issue. We also think that there will need to be some central source, tracking what level of fees might represent good value for money.
- 9.72 We also welcome the Government’s commitment to review this issue in 2017. We recommend that the review should specifically consider whether the new cost structure has incentivised short-term trading over long-term investment and if so, what measures can be taken to reduce this effect.

CHOSEN FUNDS

- 9.73 Under the Government’s proposals, trustees and IGCs will be under specific duties to review default investment strategies. However, at present there are no equivalent duties to review the strategies of chosen funds.

⁷¹ FCA Handbook COBS 11.6.3R(3)(a)-(b).

⁷² Financial Conduct Authority, *Consultation on the use of dealing commission rules* (November 2013) CP 13/17 para 2.17.

⁷³ Above, para 2.26.

⁷⁴ Financial Conduct Authority, *Changes to the use of dealing commission rules: feedback to CP13/17 and final rules* (May 2014) PS14/7.

- 9.74 Many consultees thought that it was important to keep investment strategies under review, as markets evolve over time. Legal & General Investment Management said:

It is important that investment strategies are reviewed over time. It is critical that pension providers keep up to date with macro and socio-economic trends and invest accordingly, as these will continue to shape the system. Ageing, population growth and climate change are examples of such trends.

- 9.75 In theory it is left to individual members to review their own pensions and make changes. However, the evidence is that people do not engage with pension issues sufficiently to remember choices made several decades ago. Nor are they motivated to take the necessary action. As NEST put it:

In some cases in the NEST scheme we anticipate investing over quite long term horizons, likely in excess of 45 years for a minority of members. It's inconceivable that we wouldn't want to alter the strategy over that period of time. It's also unlikely that our beneficiaries, if it were exclusively up to them, would make expert investment choices over that time period.

- 9.76 Many consultees pointed out that if pension providers are to provide improved outcomes for members they would need the power to make unilateral changes to the contracts, when the original terms became outdated or inappropriate. The point was put clearly by Legal & General Investment Management:

The regulatory framework needs to be changed. Currently, contract-based pension providers are unable to make unilateral changes to the contracts between themselves and their members without member consent. This is logistically difficult and therefore rarely obtained.

We recommend that contract-based pension providers should be held harmless by the regulatory and legal framework for mandating investment changes where it is considered to deliver a better outcome for the membership as a whole.

- 9.77 Legal & General Independent Governance Committee also asked for providers to be given powers to change contracts:

Irrespective of an IGC's determinations and recommendations, Providers cannot make unilateral changes to, in particular, members' investments or Selected Retirement Ages despite the potential for a member to remain in that scheme for half a century or more. Indeed contracts could be deemed void if one party were to be given untethered rights in this regard, and/or actions taken by providers in the interests of the many could give rise to member complaints and/or regulatory censure in respect of the few who do not benefit from that action.

- 9.78 Similarly, the NAPF thought that providers needed more power to take action when schemes no longer work in members' best interests:

It is changes to the wider economic environment, the law, and the consumer's personal circumstances that have the most impact. These factors may mean that a contract entered into 20 years previous no longer remains suitable, or even fit for purpose. However, currently there are many laws discouraging a provider from effectively "selling" a new product, or even a new investment strategy, to the consumer, and little to encourage that provider to approach the consumer with a deal that would better suit them. More thought therefore needs to be given to this situation, because even with the best will in the world, the provider may have limited ability to do better for the consumer under the present structure.

- 9.79 The Government has recognised this concern, noting that contract-based pension providers may be restricted in acting on the recommendations of their IGCs by the terms of members' contracts. In the Government's opinion, the extent of the problem is likely to become more apparent following the conclusion of the OFT's audit of high cost and legacy schemes, which should provide further information about the extent to which contract terms may prevent providers from making changes that are in members' interests.⁷⁵ Following the audit, the Government will consider, with the FCA, whether there is a case for government intervention.⁷⁶

The way forward: changing contract terms

- 9.80 We welcome the Government's commitment to return to this issue. The issue clearly raises legal difficulties. Contract-based providers may be constrained in their ability to make changes to contract terms or move savers to other funds without their express agreement. Yet the lack of engagement with pensions means that many savers may fail to engage with letters from their provider, even if it is in their interests to do so. If the OFT's audit shows that there is a problem, we think that this may require a regulatory solution.
- 9.81 One solution would be to allow specified changes on an opt out basis. In other words, where changes meet clearly defined standards of savers' best interests, regulations could allow the changes to be made unless the saver specifies that they do not wish the changes to take place. There would need to be a procedure for notifying savers and setting time periods for savers to reply.

CONCLUSION

- 9.82 There are clear issues with governance in both trust-based and contract-based DC workplace pensions. The OFT highlighted a lack of member engagement, along with higher charges and a lack of review, as the main challenges for the industry. As auto-enrolment is extended to smaller employers, the need to address these challenges is becoming more pressing.

⁷⁵ Better workplace pensions: Further measures for savers (2014) Cm 8840 p 21.

⁷⁶ Above, p 21.

- 9.83 We welcome the Government's response to these issues. It is important that all pension schemes meet minimum governance standards, regardless of whether they are trust-based or contract-based. We particularly welcome independent governance committees as a move towards providing greater oversight of members' interests in contract-based pensions. These committees should be under duties to act, with reasonable care and skill, in the interests of members.
- 9.84 However, longer term challenges will remain. The exclusion of transaction costs from the scope of the charge cap may lead to a "water-bed" effect, and there are still issues with members' investment choices becoming unsuitable over time. It is important that trustees and IGC members are given training and support on this issue. We also think that there will need to be some central source, tracking what level of fees might represent good value for money
- 9.85 We also welcome the Government's commitment to consider whether contract-based providers may be restricted in making changes to members' investments by the terms of members' contracts, following the OFT's audit of high cost and legacy schemes. Providers may need the ability to change contract terms, unless the saver indicates a desire to opt out of change.
- 9.86 For the purposes of this report, we make the following recommendations.
- 9.87 **We recommend that independent governance committees embedded within pension providers owe a statutory duty to scheme members to act, with reasonable care and skill, in members' interests. This duty should not be excludable by contract.**
- 9.88 **We recommend that pension providers should be required to indemnify members of their independent governance committees for any liabilities they incur in the course of their duties.**
- 9.89 **We recommend that, as part of its review of the default fund charge cap in April 2017, the Government should specifically consider whether the design of the cap has incentivised trading over long-term investment and, if so, what measures can be taken to reduce this effect.**

CHAPTER 10

DUTIES IN THE INVESTMENT CHAIN: THE CURRENT LAW

- 10.1 In the Consultation Paper we described the complex “chains of intermediation” which exist in investment markets between the original saver and the company in which they invest.¹ We illustrated this by tracing the investment chain in a typical defined benefit pension scheme. Pension schemes have relatively few in-house staff. Instead they rely on advisers, including actuaries and investment consultants. The trustees give a mandate to one or more investment managers, who may invest in a variety of assets, including direct investment in equities or collective investment schemes. Investment managers do this by using investment platforms, brokers and custodians.
- 10.2 We have been asked to consider how fiduciary duties apply along this chain. Specifically, our terms of reference ask us to investigate the extent to which, under existing law, fiduciary duties apply to:
- (a) intermediaries (including investment managers and pension scheme trustees) investing on behalf of others; and
 - (b) those providing advice or other services to those undertaking investment activity.
- 10.3 We have already considered the duties owed by pension trustees in depth. Here we consider how fiduciary duties apply to the many other intermediaries in the chain.
- 10.4 We approach these questions with extreme caution. In Chapter 3 we explained that fiduciary duties operate in the background of other duties. Typically, claims against investment intermediaries allege a variety of causes of action, including breach of contract, negligence and misrepresentation, often accompanied by a claim for breach of fiduciary duty. Lord Millett has commented that:
- Plaintiffs and their advisers have discovered the apparent advantages of alleging breach of trust or fiduciary duty, with the result that a statement of claim is considered to be seriously deficient if it does not contain inappropriate references to these concepts which are often scattered throughout the pleadings with complete abandon.²

¹ CP 215, Chapter 3.

² P Millett, “Equity’s place in the law of commerce” (1998) 114 *Law Quarterly Review* 214 at 217.

- 10.5 It is relatively easy to list the intermediaries who have the potential to owe fiduciary duties. However, whether they will be found to owe such duties, and the extent of those duties, will always depend on the facts of the case. As Justice Frankfurter of the US Supreme Court put it:

To say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?³

- 10.6 In answering these questions, the courts will begin by looking at the terms of any contract. Investment intermediaries are often highly sophisticated, and many will have individually negotiated the contracts that spell out their rights, duties and liabilities. The courts will also take into account the commercial nature of these relationships, and the impact of any regulatory rules.
- 10.7 In this Chapter we concentrate on describing the current law; we evaluate whether the law is right in the next Chapter. We begin by describing Professor Kay's view of the role of fiduciary duties in financial markets and explain how it is different from the approach the courts currently take.
- 10.8 We then discuss which intermediaries have the potential to owe fiduciary duties. This, however, is only the starting point. As we explain, the courts are often reluctant to impose fiduciary duties on commercial parties, and where they do, they will interpret those duties subject to the contract terms and the regulatory rules. Furthermore, an intermediary's duties tend to be confined to its immediate client rather than extending to the end-investor. We conclude that, as presently understood, fiduciary duties do not appear to be an effective means of achieving Professor Kay's policy aims.

³ *Securities and Exchange Commission v Chenery Corporation* (1943) 318 US 80 at 85-86. See also *Re Goldcorp Exchange Ltd* [1995] 1 AC 74 at 98, where Lord Mustill said that "to describe someone as a fiduciary, without more, is meaningless".

THE KAY REVIEW'S RECOMMENDATION

- 10.9 Professor Kay recommended that all those in financial markets should apply fiduciary standards in their dealings with each other whenever they exercise discretion over the investments of others or give advice on investment decisions. He thought that fiduciary standards “require that the client’s interests are put first, that conflict of interest should be avoided, and that the direct and indirect costs of services provided should be reasonable and disclosed”.⁴ Furthermore, he thought that these obligations should be independent of the classification of the client, and should not be capable of being contractually overridden.⁵ He said that intermediaries’ legal responsibilities should be directed to the interests of end-investors:

The fiduciary obligation is not relieved by the identification of the immediate client as a professional or wholesale investor. The economic interest in all monies in the investment chain lies with savers, and it is to the interests of these savers that the legal and regulatory responsibilities of equity investment intermediaries must be directed.⁶

The suggestion that an intermediary’s legal responsibilities should be directed to end-investors raises a further question: should intermediaries owe fiduciary duties only to their immediate clients, or should they also be owed to end-investors?

- 10.10 In its response to the Kay Review, the Government commented that the word “fiduciary” could be used in different ways. It therefore elected to avoid the word. Instead, the response sets out a principle for all participants in the equity investment chain.⁷ Among other things, it states that participants “should act in the best long-term interests of their clients or beneficiaries”. As with Professor Kay’s recommendations, the principle should be “independent of the classification of the client” and “should not be contractually overridden”. It says that “this means ensuring that the direct and indirect costs of services provided are reasonable and disclosed”. The Government asked the FCA to consider to what extent current regulatory rules in this area align with this principle.⁸
- 10.11 As we shall see, these principles differ from the approach that the courts currently take. The courts are influenced by client classifications. They have been reluctant to override the contractual arrangements made between sophisticated parties, or to add new duties to the detailed rules imposed by the regulators. Furthermore, intermediaries’ duties tend to be owed to their immediate client rather than the end-investor.

⁴ J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012) p 65.

⁵ Above, Recommendation 7.

⁶ J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012) para 9.9.

⁷ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The Government Response to the Kay Review* (November 2012) para 2.8. For the full principle see para 1.13 above.

⁸ Above, para 3.35.

WHO MIGHT BE CONSIDERED A FIDUCIARY?

- 10.12 As we explore below, many investment intermediaries have the potential to owe fiduciary duties. This will depend on the function they perform and the nature of their relationship with their client.
- 10.13 Investment intermediaries may carry out a variety of functions. For example, a broker may provide investment advice in addition to executing commissions. The courts have consistently declined to be bound by parties' choice of label: they will look to substance over form.⁹ The following discussion has therefore been arranged in terms of the service being provided, rather than the identity of the participant in question.

Advice

- 10.14 Those who provide investment or other financial advice may owe fiduciary duties to their clients. A leading case on this point is the decision of the High Court of Australia in *Daly v Sydney Stock Exchange Ltd*.¹⁰ The claimant in that case had sought investment advice from a broker, who had advised the claimant not to invest on the stock exchange, and instead to lend the money to the broking firm. The broker then became insolvent.
- 10.15 Importantly, the claimant in *Daly* was not a pre-existing client of the broking firm, so there was no possibility of fiduciary duties arising out of the principal-agency relationship that applies when a broker buys and sells investments on behalf of its client. However, the High Court of Australia held that the giving of advice was sufficient to bring about a fiduciary relationship. As Justice Brennan noted:

Whenever a stockbroker or other person who holds himself out as having expertise in advising on investments is approached for advice on investments and undertakes to give it, in giving that advice the adviser stands in a fiduciary relationship to the person whom he advises. The adviser cannot assume a position where his self-interest might conflict with the honest and impartial giving of advice.¹¹

⁹ *Kennedy v De Trafford* [1897] AC 180 at 188; *Garnac Grain Co. Inc. v H.M.F. Faure and Fairclough Ltd* [1968] AC 1130 at 1137.

¹⁰ (1986) 160 CLR 371.

¹¹ Above, at 385.

10.16 The same issue arose in the Supreme Court of Canada in *Hodgkinson v Simms*,¹² where a stockbroker approached an accountant for tax advice. In reliance on the accountant's advice, the stockbroker purchased several properties. It later transpired that the accountant had an interest in these properties which he had failed to disclose. The court found that the circumstances gave rise to a fiduciary relationship. In his judgment, Mr Justice La Forest identified five interrelated factors to be considered in determining whether financial advisers stand in a fiduciary relationship with their clients:¹³

- (1) *Vulnerability* - the degree of vulnerability of the client that exists due to such things as age or lack of language skills, investment knowledge, education or experience in the stock market.
- (2) *Trust* - the degree of trust and confidence that a client reposes in the adviser and the extent to which the adviser accepts that trust.
- (3) *Reliance* - whether there is a long history of relying on the adviser's judgement and advice and whether the adviser holds him or herself out as having special skills and knowledge upon which the client can rely.
- (4) *Discretion* - the extent to which the adviser has power or discretion over the client's account.
- (5) *Professional Rules or Codes of Conduct* - help to establish the duties of the adviser and the standards to which the adviser will be held.

10.17 However, the finding of a fiduciary relationship whenever financial advice is given to another is not inevitable.¹⁴ It has been said that "the mere giving of advice does not convert a business relationship ... into a fiduciary relationship".¹⁵ What is essential is that the adviser must have given advice "in the relevant sense for the purpose of liabilities as a fiduciary".¹⁶ In a subsequent case, it was said that:

the fiduciary relationship between financial adviser and client arises because the financial adviser, having held itself out as an adviser on matters of investment, undertakes a particular financial advisory role for the client.¹⁷

¹² [1994] 3 SCR 377.

¹³ This summary is taken from the judgment of Gillese JA in *Hunt v TD Securities Inc.* (2003) 66 OR (3d) 481 at 490-491.

¹⁴ As Joseph Campbell, a former judge of the New South Wales Court of Appeal has noted, "an unqualified person volunteering stock exchange tips in the pub probably owes no fiduciary duty": J Campbell, *Fiduciary Relationships in a Commercial Context* (March 2014) n 34, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2404202.

¹⁵ *Warren v Percy Wilson Mortgage and Finance Corporation* (1984) 472 NE 2d 364 (Ohio) at 367, by Black J

¹⁶ *Pilmer v Duke Group Ltd (in liquidation)* (2001) 207 CLR 165 at 197.

¹⁷ *Aequitas v Aefc* [2001] NSWSC 14 at [307]. See also *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Limited (ACN 113 114832) (No. 4)* [2007] FCA 963 at [283].

Actuarial services

- 10.18 Whilst there appears to be no authority directly on point, a leading textbook suggests that actuaries will usually be in fiduciary relationships with their clients.¹⁸ The same work notes that:

In practice the most important facet of the duty is likely to be the duty to avoid conflicts of interest. ... Actuaries are frequently required to produce certificates or valuations which are likely to be relied on by parties with conflicting interests.¹⁹

- 10.19 The potential for conflicts of interest was raised by the Morris Review, which reported concern about the potential for conflicts of interest when the actuary to a pension scheme²⁰ advises both the pension scheme trustees and the scheme sponsor. It stated:

The Scheme Actuary advises the trustees on the valuation of the scheme's assets and liabilities and the rate of contribution necessary to meet the liabilities. Trustees represent scheme members' interests and are likely to want to ensure that security for members' likely benefits is maximised, while scheme sponsors may be concerned about minimising the cost of the scheme. This may lead to potential conflicts of interest when the same actuarial adviser advises both parties. The review recommends that trustees, the scheme sponsor and the Scheme Actuary should explicitly agree that there are no material conflicts of interest prior to the Scheme Actuary advising both the trustees and the scheme sponsor. If at any point, any of the three parties i.e. the trustees, the Scheme Actuary or the scheme sponsor, deem that a material conflict of interest has emerged then the trustees should have the option to retain the existing adviser and the scheme sponsor should secure separate actuarial advice.²¹

- 10.20 In Chapter 3 we explained that the key test is whether there is a legitimate expectation that one party will act in another's interest, with discretion, power to act and vulnerability as indicators of such an expectation.²² It is possible that these principles might apply to an actuary.

¹⁸ *Jackson & Powell on Professional Liability* (7th ed 2011) para 18-017.

¹⁹ Above, para 18-018.

²⁰ Section 47(1)(b) of the Pensions Act 1995 requires occupational pension schemes (unless exempt) to have a scheme actuary appointed by the trustees or managers of the scheme.

²¹ D Morris, *Morris Review of the Actuarial Profession: Final Report* (March 2005) p 6.

²² See para 3.24 above.

Investment management

- 10.21 Investment managers play an important role both in the institutional investment market and the retail market. The Investment Management Association has reported that, in April 2014, the industry had £788 billion in funds under management. In the same month, they reported £2.9 billion in net retail sales. The best selling asset class was UK equity funds, with net retail sales of £644 million.²³
- 10.22 It has been argued that there is “a particularly clear basis” for investment managers to owe fiduciary duties to their clients.²⁴ Whilst there is no authority directly on point, in *Ata v American Express Bank Limited*²⁵ Mr Justice Rix reasoned that an investment manager with a discretionary right to trade on a client’s behalf was in a fiduciary position. Similarly, in *Diamantides v JP Morgan Chase Bank*,²⁶ it was said that:

It would be unusual for an investment manager acquiring and managing a portfolio of investments under a formal management agreement not to owe duties of care and duties of a fiduciary nature to the other party to the agreement.²⁷

²³ The statistics are available at <http://www.investmentfunds.org.uk/press-centre/2014/press-release-statistics0414/>.

²⁴ D Frase, “Conflicts of interest” (2012) 97(Jun) *Compliance Officer Bulletin* 1 at 6. See also J Penner, “Exemptions” in P Birks and A Pretto, *Breach of Trust* (1st ed 2002) p 245.

²⁵ 7 October 1996 (unreported, Rix J). This part of Rix J’s judgment was not disturbed by the Court of Appeal in its judgment reported in *The Times*, 26 June 1998.

²⁶ [2005] EWCA Civ 1612.

²⁷ Above, at [27], by Moore-Bick LJ.

- 10.23 A similar approach has been taken by courts in Canada.²⁸ In *Ridel v Cassin*,²⁹ the Ontario Superior Court of Justice noted that “frequently, a discretionary managed account will be found to give rise to a fiduciary relationship”.³⁰ In the United States, the position, at least in relation to pension trusts, is more certain. Under the Employee Retirement Income Security Act (ERISA) in the United States, both trustees and those with discretionary authority or control over the management or disposition of pension assets are subject to fiduciary standards.³¹

Investment managers and pensions

- 10.24 Investment managers’ duties will be read subject to the investment mandate. Where investment managers act for pension trustees, the mandate will normally specify the trustees’ strategy in terms of asset allocation and acceptable risk. It will also set out the scope of the manager’s discretion. For example, the mandate might give the investment manager discretion to pick investments as they see fit in order to meet the strategic requirements, or it might be more detailed and state that only certain types of investments can be made. Alternatively, it might require that all investments are approved directly by the trustees.
- 10.25 Where investment managers owe fiduciary duties, these will usually be owed to the manager’s principal. In a pension context, this means that they would be owed to the pension trustees. We have considered whether an investment manager might also be held to owe duties to the scheme members.

²⁸ D Busch and D DeMott, *Liability of Asset Managers* (1st ed 2012) at para 14.27. See also the decision of the Ontario Superior Court of Justice in *Vipond v AGF Private Investment Management* 2012 ONSC 7068 at [211], where the court found that, on the facts, there was a fiduciary relationship between an investment manager and his client. In Quebec, where a manager is given full discretion over a client’s portfolio and is acting within the capacity of an investment manager (as defined in MiFID), they are likely to be considered an administrator of the property of others, and so subject to fiduciary-like obligations under Title Seven of the Quebec Civil Code (CCQ): D Busch and D DeMott, *Liability of Asset Managers* (1st ed 2012) paras 14.33-14.34.

²⁹ 2013 ONSC 2279.

³⁰ Above, at [193], citing *Davidson v Noram Capital Management Inc.* (2005) 13 BLR (4th) 35; *Vipond v AGF Private Investment Management* 2012 ONSC 7068. Compare *Zraik v Levesque Securities Inc.* (2001) 153 OAC 186, where the Ontario Court of Appeal upheld the holding of a trial judge who concluded that there was insufficient vulnerability to give rise to a fiduciary relationship, in part because the investor made his own evaluation of the commodities he was interested in, gave instructions for every trade, received advice but did not always follow it.

³¹ 29 United States Code § 1002(21). The concept of fiduciary duties under ERISA is broader than that under English law: see ERISA 29 United States Code § 1104(a)(1). See also *Lowen v Tower Asset Management* (1987) 829 F 2d 1209.

- 10.26 In Chapter 4, we explained that where pension trustees delegate their function to an investment manager, the manager is subject to duties under the pensions legislation. In particular:
- (1) Investment managers must exercise their discretion in accordance with the Investment Regulations.³² This includes the requirement in regulation 4(2) that the investment of scheme assets is in the best interests of members and beneficiaries.
 - (2) Investment managers are prohibited from excluding or limiting their liability to take care or exercise skill in the performance of any investment functions.³³ This is in contrast to investment managers in other circumstances, who may limit their liability.
- 10.27 It is possible that the duty of the investment manager to act in the best interests of members would be interpreted as meaning that the investment manager owes a duty directly to the scheme members. However, the issue is far from certain.
- 10.28 There is Australian authority which suggests that, in an exceptional case, an agent of a trustee may be in a direct fiduciary relationship with the beneficiaries of the trust.³⁴ Again this suggests that, in rare cases, investment managers might owe fiduciary duties directly to the beneficiaries of a pension trust.

Brokerage

- 10.29 A broker entering a market to execute an order on behalf of a client may retain an element of discretion to decide who to trade with, and at what price. Whilst the relationship between a broker and client is not in itself a fiduciary relationship,³⁵ there is considerable authority holding that a broker who is engaged to buy or sell shares on behalf of his client may be subject to fiduciary duties when buying and selling.³⁶ For example, in *Hancock v Smith*,³⁷ delivering share certificates to a broker with instructions to sell was held to give rise to a fiduciary relationship.

³² Pensions Act 1995, s 36(1); Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 4.

³³ Pensions Act 1995, s 33(1)(b).

³⁴ *Australian Securities Commission v AS Nominees Limited* (1995) 62 FCR 504.

³⁵ *Hunt v TD Securities Inc.* (2003) 66 OR (3d) 481 at 489, citing *Chesebrough v Willson* [2002] OJ No 4299 (QL), 166 OAC 119 (CA) at [2].

³⁶ *Armstrong v Jackson* [1917] 2 KB 822; *Christoforides v Terry* [1924] AC 566 at 574; *Thornley v Tilley* (1925) 36 CLR 1; *Erskine, Oxenford & Co. v Sachs* [1901] 2 KB 504.

³⁷ (1889) 41 Ch D 456.

- 10.30 The nature of a broker's duties will, however, vary depending on the nature of the services provided. A client that has a discretionary account with their broker is in a very different situation to a client whose broker provides "execution-only" services. As Mr Justice Forsyth noted in the Canadian case of *Kent v May*:

[O]ne should consider the broker-client relationship to be a spectrum. At one end is a relationship of full trust and advice. The broker effectively makes all the decisions because of the great reliance and trust reposed in him or her by the client This is exacerbated where the account is discretionary, such that the broker has the authority to make trades without the client's consent or even knowledge ... Obviously, there is a fiduciary relationship at this end of the spectrum At the other end is a relationship where the broker is merely an "order-taker" for the client, the client does not rely on any advice from the broker, and the broker had no discretion Relationships at this end of the spectrum lack the elements of a fiduciary relationship. Most cases fall somewhere in the middle³⁸

Custodial services

- 10.31 Where investors invest directly in shares electronically, the legal title to the shares will normally be held by a custodian. As we discuss in Chapter 11, the custodian will not necessarily have a direct relationship with the end-investor: shares are often held in chains of "intermediated shareholdings". For example, a custodian may hold the title to shares on behalf of an investment platform, that in turn holds shares on behalf of a pension fund. Both the custodian and the investment platform may lend stock to those wishing to take "short positions", betting that the price of the share may fall.
- 10.32 This means that custodians may potentially owe duties to the party with which they have contracted to provide custodial services ("the contracting party"), and to the end-investor. We discuss both of these scenarios below.

Custodian — contracting party

- 10.33 The courts have recently acknowledged that, notwithstanding that a commercial banking relationship will not generally give rise to fiduciary duties,³⁹ a bank may be subject to fiduciary duties in relation to custodial activities (as well as in relation to its activities as a stock lending agent).⁴⁰ However, this will ultimately depend on the facts of the case.

³⁸ (2001) 298 AR 71 at [51]-[53], affirmed (2002) 317 AR 381 (CA). There is a useful discussion of industry practice in the judgment of Hamblen J in *Redmayne Bentley Stockbrokers v Isaacs* [2010] EWHC 1504 (Comm) at [35]-[40].

³⁹ *JP Morgan Chase Bank v Springwell Navigation Corp* [2008] EWHC 1186 (Comm) at [573].

⁴⁰ *Första AP-Fonden v Bank of New York Mellon* [2013] EWHC 3127 (Comm) at [173]. See also *JP Morgan Chase Bank v Springwell Navigation Corp* [2008] EWHC 1186 (Comm) at [573].

10.34 In *Första AP-Fonden v Bank of New York Mellon*,⁴¹ the claimant was a Swedish pension fund that brought a claim against Bank of New York Mellon, the fund's custodian, for losses sustained as a result of stock lending carried out by the bank. Mr Justice Blair held that, although the relationship between the fund and custodian was one that was capable of giving rise to fiduciary duties on the part of the bank (in its capacity as custodian),⁴² no fiduciary duties were owed on the facts.⁴³ In finding that fiduciary duties were not owed in this case, the court was influenced by the contract terms, which acknowledged that conflicts of interest may arise, and permitted the bank to enter into transactions in which it had an interest without making disclosure.⁴⁴ The use of the term "fiduciary" in the bank's marketing material was not conclusive.⁴⁵

Custodian — end-investor

10.35 The decision in *Första* only concerns the direct relationship between an institutional investor (in that case, a pension fund) and a custodian bank. In other words, it only goes so far as to say that a custodian may owe fiduciary duties to the investor where it is appointed *directly* by the investor. The position as regards a custodian's duties to an end-investor is more difficult.

10.36 In Chapter 11 we describe how securities are often held through multiple tiers of holdings, making it necessary to trace "ownership" from the top-tier down through various tiers and ultimately to the investor at the bottom. We explain that each owner will usually be taken to hold a beneficial interest under a trust.⁴⁶ The chain of intermediation is therefore a chain of sub-trusts.⁴⁷

10.37 If the chain of intermediation is seen as a series of trusts, then it is likely that a court will find that any fiduciary duties will only be owed by an intermediary to the next tier down, and not to the ultimate investor. For example, where a pension scheme holds through an investment platform, which holds through a custodian, the custodian may owe fiduciary duties to the investment platform by virtue of their trustee-beneficiary relationship, but not to the pension trustees. This is consistent with the "no-look-through" principle, under which an investor may only look to its immediate intermediary, and not through the chain to upper-tier intermediaries.⁴⁸

⁴¹ [2013] EWHC 3127 (Comm).

⁴² Above, at [173].

⁴³ Above, at [275].

⁴⁴ Above, at [179].

⁴⁵ Above, at [175]-[176].

⁴⁶ See paras 11.112 to 11.114 below.

⁴⁷ With the exception of the "head trust" at the top of the chain.

⁴⁸ See paras 11.115 to 11.117 below.

10.38 There is an argument that, in some cases, a sub-trust may be ignored, such that the head trustee holds directly for the beneficiary of a sub-trust. In other words, the chain of intermediation is “collapsed”.⁴⁹ This argument, which has both judicial⁵⁰ and academic support,⁵¹ may apply where the sub-trusts are “bare trusts”.⁵² These are trusts where the trustees have no active duties to perform.⁵³ If even one sub-trustee in the chain of intermediation owes active duties, we think that this would preclude a direct relationship between the top of the chain and the end-investor.

10.39 A leading text on the law of custody of investments expresses the view that any duties are owed only to the immediate client:

Whatever benefits come to an investor must come through the intermediary holding directly for him, not the intermediary holding the underlying assets under a main trust at a different tier. It is only with intermediaries holding directly for them that investors enjoy direct dealings⁵⁴

10.40 It appears that custodians will owe duties to the end-investor when they are appointed by the end-investor themselves. However, where an end investor holds investments through a chain of intermediaries, it is unlikely that the end-investor could sue a custodian directly for breach of fiduciary duty, even if the custodian had caused them loss by inappropriate stock lending. In Chapter 11, we consider whether the practice of stock lending requires further regulation.

WHAT IS THE CONTENT OF THE FIDUCIARY DUTIES?

10.41 To say that someone is capable of being a fiduciary is only the starting point. The next question is: what fiduciary duties are owed? This will depend on the facts of the case, and it is only possible to set out broad principles.

⁴⁹ A Austen-Peters, *Custody of Investments: Law and Practice* (2000) paras 4.28-4.32.

⁵⁰ *Grainge v Wilberforce* (1889) TLR 436 at 437; *Grey v Inland Revenue Commissioners* [1958] Ch 375 at 382; *Re Lashmar* [1891] 1 Ch 258 at 267 and 269; *Corin v Patton* (1990) 169 CLR 540 at 579; *ISPT Nominees Pty Ltd v Chief Commissioner of State Revenue* [2003] NSWSC 697 at [243]-[270]. The analysis of many of these cases has been criticised by Austen-Peters: see A Austen-Peters, *Custody of Investments: Law and Practice* (2000) paras 4.28-4.32.

⁵¹ For example, see *Lewin on Trusts* (18th ed 2012) para 1-31, where it is said that “if A holds property in trust for B absolutely and B holds his equitable interest in the property in trust for C absolutely, and if B becomes a mere repository for C, B drops out of the relationship and A holds the property in trust for C.” See also *Underhill and Hayton Law of Trusts and Trustees* (18th ed 2010) para 12.15; J Heydon and M Leeming, *Jacobs’ Law of Trusts in Australia* (7th ed 2006) at [2312].

⁵² For the contrary argument, see *Meagher, Gummow and Lehane’s Equity: Doctrines and Remedies* (4th ed 2002) at [7-205].

⁵³ *Christie v Ovington* (1875) 1 Ch D 279; *Re Cunningham and Frayling* [1891] 2 Ch 567.

⁵⁴ A Austen-Peters, *Custody of Investments: Law and Practice* (2000) para 4.32.

- 10.42 These principles suggest that the courts will be reluctant to apply fiduciary duties to sophisticated parties in a contractual relationship, especially to an intermediary who has abided by the regulatory rules. Below we explain that the courts respect commercial relationships; they will view fiduciary duties as subject to the terms of the contract; and they will be heavily influenced by regulatory rules.

Fiduciary duties and commercial relationships

- 10.43 There is some reluctance to assign fiduciary obligations to a commercial relationship.⁵⁵ In *Vercoe v Rutland Fund Management Ltd*, Mr Justice Sales explained that:

In ordinary commercial relationships, such [fiduciary] obligations have not been bargained for and agreed, and create rights and remedies going well beyond the ordinary contractual rights and remedies which have been recognised and worked out over the years by the common law to strike the appropriate balance between the competing interests of parties to such relationships.⁵⁶

- 10.44 The courts treat the parties to commercial transactions as already having had an adequate opportunity to prescribe their obligations, and to outline what remedies will be available to them.⁵⁷ In commercial relationships, the parties are expected to be the authors of their own rights and obligations. It has been said that fiduciary duties should only be imposed upon them where it is “necessary and appropriate” to give effect to the expectations they could properly entertain in consequence of their contract, given the context.⁵⁸ The courts will be vigilant against any attempt to use fiduciary duties to overcome shortcomings in the arrangements between the parties.⁵⁹
- 10.45 In *DHL International (NZ) Ltd v Richmond Ltd*, it was said that commercial relationships often preclude the existence of fiduciary obligations:

Arm’s length commercial transactions rarely give rise to fiduciary obligations. They are matters of contract where the parties reasonably expect their contract to govern, rather than matters of conscience.⁶⁰

⁵⁵ See *Re Goldcorp Exchange Ltd* [1995] 1 AC 74 at 98; *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41 at 149; P Millett, “Equity’s Place in the Law of Commerce” (1998) 114 *Law Quarterly Review* 215. Compare J Lehane, “Fiduciaries in a Commercial Context” in P Finn (ed), *Essays in Equity* (1985) p 104.

⁵⁶ [2010] EWHC 424 (Ch) at [352].

⁵⁷ Kennedy J “Equity in a Commercial Context” in P Finn (ed), *Equity and Commercial Relationships* (1st ed 1987) p 15. Scottish examples of this include *Lothian v Jenolite* 1969 SC 111 and *Raymond Harrison & Co’s Trustee v North West Securities* 1989 SLT 718.

⁵⁸ P Finn, “Fiduciary law and the modern commercial world” in E McKendrick (ed), *Commercial Aspects of Trusts and Fiduciary Obligations* (1992) p 14.

⁵⁹ *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41 at 147.

⁶⁰ [1993] 3 NZLR 10 at 22.

- 10.46 Similarly, in *Hospital Products Ltd v United States Surgical Corporation*, Chief Justice Gibbs said that:

The fact that the arrangement between the parties was of a purely commercial kind and that they had dealt at arm's length and on an equal footing has consistently been regarded by this Court as important, if not decisive, in indicating that no fiduciary duty arose.⁶¹

- 10.47 This is not to say that fiduciary duties will never arise in commercial relationships. There is scope for the courts to find fiduciary relationships on the facts of any given case. However, a party claiming that a fiduciary relationship has arisen may face a more difficult task when the relationship is a commercial one, at least where the relationship in question is not one that is considered to be clearly or traditionally fiduciary.⁶²

The impact of contract

- 10.48 Professor Kay thought that fiduciary duties should not be capable of being contractually overridden. He saw fiduciary duties as arising from the factual relationship, such as the advice given.⁶³ Again, the principle advocated in the Government's response to the Kay Review states that the obligation to act in the best interests of clients may not be contractually overridden.⁶⁴

- 10.49 This is not the approach currently taken by the courts in England & Wales, or by the courts in Australia, New Zealand and Canada. The courts have consistently held that fiduciary duties are subject to modification by contract. They are "moulded according to the nature of the relationship and the facts of the case".⁶⁵ In this sense, they are only default rules out of which the parties may contract freely. In *Henderson v Merrett Syndicates Ltd*, Lord Browne-Wilkinson explained that:

The extent and nature of the fiduciary duties owed in any particular case fall to be determined by reference to any underlying contractual relationship between the parties. ... The existence of a contract does not exclude the co-existence of concurrent fiduciary duties (indeed, the contract may well be their source); but the contract can and does modify the extent and nature of the general duty that would otherwise arise.⁶⁶

⁶¹ (1984) 156 CLR 41 at 70.

⁶² P Finn, "Fiduciary law and the modern commercial world" in E McKendrick (ed), *Commercial Aspects of Trusts and Fiduciary Obligations* (1992) p 13.

⁶³ See para 10.9 above.

⁶⁴ See para 1.13 above.. The "best interests" duty under the FCA Handbook cannot be excluded or limited: see paras 8.15 to 8.17 above.

⁶⁵ *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41 at 102, by Mason J.

⁶⁶ *Henderson v Merrett Syndicates Ltd* [1995] 2 AC 145 at 206.

The Law Commission's previous views

10.50 In the 1990s there had been some controversy over the relationship between fiduciary duties and contract terms. In our 1992 consultation paper,⁶⁷ we said that there were two possible ways of analysing the issue.

- (1) The “status-based” approach stated that the courts should look at the essence of the relationship when determining the rights and obligations of the parties, and then refuse to give effect to clauses which were incompatible with it.⁶⁸
- (2) The “contract first” approach stated that the court must have regard to the terms of the contract when determining whether a relationship is fiduciary and, if so, the scope of the fiduciary’s duties.⁶⁹

10.51 We preferred the “contract first” approach, although we thought that the position was unclear.⁷⁰ Following the 1992 consultation paper, but before our 1995 report, the case of *Kelly v Cooper*⁷¹ was decided, concerning the duties of an estate agent.⁷² Here, Lord Browne-Wilkinson made a strong statement in favour of the “contract first” approach:

It is not possible to say that all agents owe the same duties to their principals: it is always necessary to have regard to the express or implied terms of the contract.⁷³

10.52 We commented that this confirmed the “contract first” approach: express terms would be central to the court’s assessment of the existence and scope of any fiduciary duties. We said that after *Kelly* there was “virtual unanimity” amongst consultees that express terms were effective in excluding, limiting or modifying fiduciary obligations.⁷⁴

⁶⁷ Fiduciary Duties and Regulatory Rules (1992) Law Commission Consultation Paper No 124.

⁶⁸ Above, para 3.3.9

⁶⁹ Above, para 3.3.10.

⁷⁰ Above, para 3.3.11.

⁷¹ [1993] AC 205.

⁷² We discuss this case at paras 3.39 to 3.40 above.

⁷³ [1993] AC 205 at 214.

⁷⁴ Fiduciary Duties and Regulatory Rules (1995) Law Com No 236 para 7.3. The courts have confirmed the “contract first” approach: see *Fattal v Walbrook Trustees (Jersey) Ltd* [2010] EWHC 2767 (Ch) at [113].

- 10.53 We remain of this view. Where the contract is the foundation of the relationship between the parties, the courts should look first at what the parties have undertaken. As Paul Finn states:

The distinctive attribute of ... relationships founded upon and defined by agreement is that the party for whose benefit the relationship exists can himself stipulate what powers and duties can be exercised or discharged for him or on his behalf. In addition he can stipulate how they are to be exercised or discharged – he can, if he is so minded, control through his agreement how his interests are to be served. If he can do this there is no compelling reason for Equity to protect him by imposing a general obligation on his functionary having a similar object.⁷⁵

- 10.54 Where a fiduciary relationship arises, it must accommodate itself to the terms of any contract between the parties. The courts will not superimpose a fiduciary relationship upon a contract so as to alter the operation which it was intended to have according to its true construction.⁷⁶ Similarly, contract terms may be so precise in regulating what a party may do that there is no relevant area of discretion remaining and therefore no scope for the creation of a fiduciary duty.⁷⁷

The impact of regulation

- 10.55 The courts may take account of financial regulation in a number of ways. Here we discuss two: regulatory rules may be incorporated into the contract between the parties, or they may inform duties owed by the parties under the general law.

Contractual incorporation

- 10.56 In our 1995 report on Fiduciary Duties and Regulatory Rules,⁷⁸ we looked in detail at whether regulatory rules could be incorporated into contracts, to take effect as contract terms. We took the view that, in some cases, the courts might incorporate regulatory rules into a contract on the grounds that they represent trade custom.⁷⁹
- 10.57 Where the courts give regulations the status of contract terms, contravention of the rules becomes actionable at common law as a breach of contract.⁸⁰

⁷⁵ P Finn, *Fiduciary Obligations* (1977) para 22.

⁷⁶ *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41 at 97.

⁷⁷ Above, at 98. See also *Paul Dainty Corporation Pty Ltd v National Tennis Centre Trust* (1990) 22 FCR 495 at 515-516, where it was said that “the authorities make it clear that equity will not impose fiduciary obligations on parties who have entered into ordinary and arm’s length commercial relationships, which fully prescribe the respective powers and duties of the parties. This is particularly so when the parties involved are substantial corporations, having equal bargaining power. There is simply no need for the intervention of equity, to imply fiduciary responsibilities, in such circumstances.”

⁷⁸ *Fiduciary Duties and Regulatory Rules* (1995) Law Com No 236.

⁷⁹ Above, paras 2.8 to 2.10.

⁸⁰ See *Jackson & Powell on Professional Liability* (7th ed 2011) para 15-021. Alternatively, the rule may operate as an exclusion clause (for example, where a rule states that a client is entitled only to a certain level of disclosure).

- 10.58 In some cases the courts have been sympathetic to this approach. For example, in *Larussa-Chigi v CS First Boston Ltd*,⁸¹ Mr Justice Thomas suggested that even if the parties had not (as he held) expressly incorporated the London Code of Conduct,⁸² the Code would have been incorporated as an implied term since it was not intended that the foreign exchange transactions in question be unregulated.⁸³ However, in most cases the courts have declined to treat regulatory rules as contract terms.⁸⁴

Informing duties under the general law

- 10.59 Rather than turn regulatory duties into contract terms, the courts have tended to interpret duties of care in line with regulatory standards. Leading textbook writers, McMeel and Virgo, summarise the courts' approach:

Where an independent common law cause of action is established, or a common law duty is held to co-exist with a statutory duty, any applicable FSA rules or guidance will be highly influential in shaping the common law standard of care. The standard of liability at common law is likely to mirror precisely the statutory regime.⁸⁵

- 10.60 Similarly, another leading textbook on professional negligence stresses that in a financial context, the "first main issue that needs to be addressed is one of regulatory application".⁸⁶ The authors conclude that:

In particular the standard of the duty of care in negligence is likely to be largely co-extensive with that imposed by the regulatory rules.⁸⁷

⁸¹ [1998] CLC 277.

⁸² The London Code of Conduct was a regulatory regime, applying to trading in the wholesale markets, published by the Bank of England until 1999 and thereafter by the Financial Services Authority.

⁸³ [1998] CLC 277 at 295.

⁸⁴ See *Redmayne Bentley Stockbrokers v Isaacs* [2010] EWHC 1504; *Wilson v MF Global UK Ltd* [2011] EWHC 138 and *Clarion Ltd v National Provident Institution* at [2000] 1 WLR 1888.

⁸⁵ *McMeel and Virgo on Financial Advice and Financial Products: Law and Liability* (Release 10 2012) para V.1.20.

⁸⁶ *Jackson & Powell on Professional Liability* (7th ed 2011) para 15-012.

⁸⁷ *Jackson & Powell on Professional Liability* (7th ed 2011) para 14-072.

10.61 This is a guideline rather than a rule. As the judge put it in *Gorham v British Telecommunications plc*, the courts can be expected to “attach considerable weight” to the content of codes drafted by “those concerned with the maintenance of proper standards”, but they are not excluded from making their own assessment of the situation.⁸⁸ Similarly, in *Seymour v Caroline Ockwell & Co*,⁸⁹ HHJ Havelock-Allen QC said that:

I accept that whilst the ambit of the duty of care owed by a financial adviser at common law is not necessarily co-extensive with the duties owed by that adviser under the applicable regulatory regime, the regulations afford strong evidence as to what is expected of a competent adviser in most situations.⁹⁰

10.62 Recent cases have addressed the interaction between duties owed under the general law and the regulatory obligations of parties under the FCA Handbook.

10.63 In *Harrison v Black Horse Ltd*⁹¹ the issue was whether the failure of lenders to tell borrowers that they had received commission for selling them payment protection insurance amounted to unfairness in the relationship between lender and borrower for the purposes of the Consumer Credit Act 1974. On appeal to the Court of Appeal, the claimant borrower argued that the size of the commission was so egregious that it gave rise to a conflict of interest which had to be disclosed. The defendant lender relied on the Insurance Conduct of Business Rules (ICOB) (in what was then the FSA Handbook), and the absence of any disclosure requirement in those rules.

10.64 The Court of Appeal found it decisive that the ICOB regime did not require the disclosure of the receipt of the commission.⁹² Lord Justice Tomlinson held:

The touchstone must in my view be the standard imposed by the regulatory authorities pursuant to their statutory duties, not resort to a visceral instinct that the relevant conduct is beyond the Pale. In that regard it is clear that the ICOB regime after due consultation and consideration does not require the disclosure of the receipt of commission. It would be an anomalous result if a lender was obliged to disclose receipt of a commission in order to escape a finding of unfairness under s.140A of the [Consumer Credit] Act but yet not obliged to disclose it pursuant to the statutorily imposed regulatory framework under which it operates.⁹³

⁸⁸ [2000] 1 WLR 2129 at 2141.

⁸⁹ [2005] EWHC 1137.

⁹⁰ Above, at [77]. The judge cited *Lloyd Cheyham & Co Ltd v Eversheds* (1985) 2 Lloyds PN 154 in support of this proposition.

⁹¹ [2011] EWCA Civ 1128. The principle in *Harrison* has recently been criticised by the Court of Appeal in *Conlon v Black Horse Ltd* [2013] EWCA Civ 1658. The court granted permission to appeal to the Supreme Court.

⁹² Above, at [43]-[47].

⁹³ [2011] EWCA Civ 1128 at [58].

- 10.65 This illustrates that the courts are reluctant to hold intermediaries liable where they have acted in accordance with the rules. The opposite side of the coin is that intermediaries who break the rules have been held liable to their clients in negligence, because the courts have interpreted their duty of care in line with the rules.
- 10.66 The case of *Loosemore v Financial Concepts* illustrates this principle.⁹⁴ A nurse opted out of her employer's occupational pension scheme and subsequently took out a personal pension scheme, following a meeting with an independent financial adviser (IFA). The IFA had breached the regulatory rules applicable at the time. The judge found that this constituted negligence; the IFA was therefore liable to compensate the claimant. He held:

The skill and care to be expected [from the IFA] would ordinarily include compliance with the rules. I should add that in comparison with what many financial advisers and companies were doing at this time – which was to encourage people to opt out and transfer, Mr Wischhusen did well. For he did give some warning. It was not, however, enough. The Financial Services Act 1986 and the rules made under it by the supervisory agencies brought in radically new standards.⁹⁵

⁹⁴ [2001] Lloyd's Rep PN 235.

⁹⁵ [2001] Lloyd's Rep PN 235 at 241-242, by HHJ Raymond Jack QC. See also *Rubenstein v HSBC Bank* [2011] EWHC 2304. *Rubenstein* was reversed in part on appeal ([2012] EWCA Civ 1184) but on other grounds.

Client classification

- 10.67 The FCA rules require firms to categorise their clients.⁹⁶ In certain circumstances, a client may be entitled to request re-categorisation.⁹⁷ Under FCA rules, where a client elects to be treated as a professional client, the client must request the categorisation in writing and the firm must then provide a clear written warning of the protections and compensation rights the client might lose.⁹⁸ In *JP Morgan Bank v Springwell Navigation Corp*,⁹⁹ JP Morgan Bank (formerly Chase Manhattan Bank or “Chase”) notified Springwell of their categorisation as sophisticated investors. Such a classification was necessary in order for Springwell to participate in the relevant programmes. Mrs Justice Gloster placed significance on these letters in determining the duties owed by JP Morgan to Springwell:

I accept that, on the evidence, the [client classification] letters were of particular significance, because they reflected a regulatory classification consciously undertaken by Chase in the absence of which Springwell would not have been permitted access to the Margin Forward Programme or, subsequently, the repurchase programme.¹⁰⁰

On appeal, Lord Justice Aikens agreed with this conclusion.¹⁰¹

- 10.68 Professor Kay thought that fiduciary standards should be independent of the classification of the client. By contrast, the courts have been influenced by the classification of the client in deciding when fiduciary duties apply.

TO WHOM ARE THE DUTIES OWED?

- 10.69 We have considered how far financial intermediaries should not only owe duties to their immediate clients but also to the end-investor. We are not aware of any cases from England & Wales concerning fiduciary duties which address this point directly. There is, however, a significant body of case law discussing when people may be under a duty of care not to cause financial loss to someone else, in the absence of a contractual relationship. The courts have held that, in the absence of a contractual relationship, duties should be owed in only limited circumstances.

⁹⁶ FCA Handbook COBS 3.3.1R.

⁹⁷ FCA Handbook COBS 3.3.2G.

⁹⁸ FCA Handbook COBS 3.5.3R.

⁹⁹ [2008] EWHC 1186 (Comm).

¹⁰⁰ Above, at [235]. This was the first of two judgments. Gloster J dealt with another point at [2008] EWHC 1793 (Comm). Certain points from both of these judgments were appealed to the Court of Appeal at [2010] EWCA Civ 1221. Only the first judgment raises relevant points.

¹⁰¹ [2010] EWCA Civ 1221 at [186].

- 10.70 In the Consultation Paper we described the House of Lords case, *Caparo Industries plc v Dickman*.¹⁰² The claimants relied on an auditor's report when making an investment in a company. The auditor's report proved to be inaccurate and the claimants suffered loss. The House of Lords held that no duty of care was owed by the auditor to future investors. The preparation of accounts was not aimed at enabling investors to make investment decisions. Instead, an auditor's duty was to the shareholders of the company. The court emphasised the importance of imposing limits on when duties of care arise in respect of pure economic loss.¹⁰³
- 10.71 Many of the cases where the courts have allowed recovery for such loss have involved negligent misstatements. For example, the House of Lords has held that an employer owes a duty of care to a former employee when giving a reference.¹⁰⁴ However, there are two cases which address whether those in the investment chain owe duties beyond their immediate clients to others in the chain.
- 10.72 In *Gorham v British Telecommunications plc*,¹⁰⁵ the claimant was the beneficiary under her husband's personal pension. Her husband had received negligent advice about his occupational pension scheme and had been sold an unsuitable personal pension plan. The Court of Appeal held that where the intermediary knew that advice about pensions was central to the interests of the customer's dependants, a duty of care was owed not just to the immediate customer but also to the intended beneficiaries.
- 10.73 This suggests that intermediaries may owe duties to others in the chain, as Professor Kay suggests. However, the case has been given limited application. In *Seymour v Caroline Ockwell & Co*,¹⁰⁶ a husband and wife sold their farm for £1.4 million and consulted an IFA, Miss Ockwell, about how best to invest the money. Miss Ockwell then consulted an "executive consultant" employed by a major insurance group, ZIFA. ZIFA recommended an offshore fund, which proved to be disastrous. The claimants sued both the IFA and ZIFA, in negligence and under the Financial Services Act 1986.¹⁰⁷

¹⁰² [1990] 2 AC 605.

¹⁰³ The term "pure economic loss" refers to economic loss which is not the consequence of damage to a person's body or property. For a fuller discussion see CP 215 paras 6.41 to 6.42.

¹⁰⁴ *Spring v Guardian Assurance* [1995] 2 AC 296.

¹⁰⁵ [2000] 1 WLR 2129.

¹⁰⁶ [2005] EWHC 1137.

¹⁰⁷ The predecessor to the Financial Services and Markets Act 2000.

- 10.74 The claimants used *Gorham v British Telecommunications plc*¹⁰⁸ to argue that ZIFA owed a duty of care directly to the claimants when giving advice to the IFA. However, the judge rejected this argument. He found that ZIFA did not owe a duty directly to the claimants – only to their immediate client, Miss Ockwell. He outlined policy reasons against imposing duties between parties who had no direct dealings with each other:

It would be a duty which by-passed the regulatory regime and side-stepped the contractual remedy. Whilst not of itself fatal, it is significant that the relevant provisions of the Adopted FIMBRA Rules ... place responsibility for recommendations and information squarely on the shoulders of the professional whose clients are relying on the advice being given. Mr and Mrs Seymour were not ZIFA's clients. They were the clients of Miss Ockwell. This structure would be avoided if a direct duty was to be imposed.¹⁰⁹

- 10.75 *Seymour* directly addresses the question of whether those who give advice to professional clients in the investment chain owe duties of care beyond their immediate clients. The courts appear reluctant to impose such duties. We believe they are likely to follow a similar approach in relation to fiduciary duties.

CONCLUSION

- 10.76 There are substantial differences between the approach currently taken by the courts and the aspiration set out in Recommendation 7 of the Kay Review.
- 10.77 First, Professor Kay saw fiduciary standards as raising regulatory requirements, rather than simply mirroring them. He thought that these standards should be independent of the classification of the client and should apply whenever participants exercised discretion over the investments of others or gave advice on investment decisions. This is also reflected in the Government's principle for participants in equity investment markets.
- 10.78 By contrast, the courts have taken a more restrictive view. They are reluctant to impose fiduciary duties in ordinary commercial relationships, and have been heavily influenced by the regulatory regime. Where an IFA, for example, is required to consider the suitability of an investment for a retail client, the courts will incorporate the suitability requirement into the IFA's duty of care towards the client.¹¹⁰ However, where intermediaries have acted in accordance with the rules, they have been reluctant to find them liable.¹¹¹

¹⁰⁸ [2000] 1 WLR 2129.

¹⁰⁹ [2005] EWHC 1137 at [143].

¹¹⁰ See *Loosemore v Financial Concepts* [2001] Lloyd's Rep PN 235; *Rubenstein v HSBC Bank* [2011] EWHC 2304.

¹¹¹ *Harrison v Black Horse Ltd* [2011] EWCA Civ 1128.

- 10.79 Secondly, Professor Kay thought that fiduciary duties should not be capable of being contractually overridden. He saw fiduciary duties as arising from the factual relationship, such as the advice given.¹¹² Again, the Government's principle states that the obligation to act in the best interests of clients may not be contractually overridden.¹¹³ The courts, however, will start with contract, and what the contract says about the duties each party owes to the other.¹¹⁴
- 10.80 Thirdly, Professor Kay argued that an intermediary's legal responsibilities should be directed not only to the immediate professional client but also to the ultimate saver. The courts have been cautious about holding that parties in the chain owe duties to others, beyond their immediate client.
- 10.81 Fiduciary duties do not appear to be an effective means of achieving Professor Kay's policy aims. Judges can only decide the cases brought before them, and those most vulnerable to poor practice may be those least able to mount legal challenges. Many will be deterred by the uncertainty of this area of law. And even if a challenge is mounted, the courts may be reluctant to interfere with a commercial relationship, and will interpret the duties owed in accordance with the contract and with the regulatory rules. In the next Chapter we consider whether there is a need for reform.

¹¹² See para 10.9 above.

¹¹³ See para 1.13 above. The "best interests" duty under the FCA Handbook cannot be excluded or limited: see paras 8.15 to 8.17 above.

¹¹⁴ See paras 10.50 to 10.54 above.

CHAPTER 11

DUTIES IN THE INVESTMENT CHAIN: A NEED FOR REFORM?

- 11.1 The Kay Review recommended that all intermediaries in the investment chain should be held to fiduciary standards. These obligations should be independent of the classification of the client and should not be capable of being contractually overridden.¹ Furthermore, these responsibilities should be directed at the end-investor.
- 11.2 As we discuss in Chapter 10, the current law is very different from the position advocated by Professor Kay. The law of fiduciary duties is extremely flexible but also inherently uncertain. The courts look at the contract first, and interpret the parties' duties to each other in line with the contract. They are often reluctant to go beyond the rules set out by Parliament and regulators. They are also cautious in finding that those in the investment chain owe duties to others beyond the immediate contractual or trust-based relationship.
- 11.3 In this Chapter we consider possible reforms to the law in this area. In particular we consider whether investors should be given greater rights to sue for breaches of Financial Conduct Authority (FCA) rules. We also consider three specific areas where change might be needed. These are: the regulation of investment consultants; the regulation of stock lending; and the law underlying the way that intermediated securities are held.

SHOULD THE LAW OF FIDUCIARY DUTIES BE REFORMED?

- 11.4 In the Consultation Paper we argued against a general reform of the law of fiduciary duties to introduce the principles set out by Professor Kay. We commented that fiduciary duties are difficult to define and inherently flexible. This is one of their essential characteristics: they form the background to other more definite duties, allowing the courts to intervene where the interests of justice require it.
- 11.5 There are major difficulties in relying on “judge-made” law to control complex and fast-moving financial markets. Judges can only decide the cases brought before them. Very few cases are brought – and those most vulnerable to poor practice may be those least able to mount legal challenges. Further, rules are developed only after the event – often long after the event. In the Consultation Paper we described the case of *JP Morgan Bank v Springwell Navigation Corp.*² The securities were bought from 1996, the loss occurred in 1998 and the Court of Appeal ruling was in 2010. When cases reach court it is too late to prevent the practice retrospectively: the courts can only provide financial redress. Large compensation payments can introduce further disruptions to the market, adding to cost and risk.

¹ J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012) Recommendation 7.

² For the Court of Appeal decision, see [2010] EWCA Civ 1221. The case is discussed in CP 215 paras 11.78 to 11.88.

- 11.6 The principles set out in the Kay Review are so far removed from the courts' interpretation of fiduciary duties that we do not think that it is possible to create the first from the second. Any attempt to change fiduciary duties through legislation would result in new uncertainties and could have unintended consequences in other areas, especially for trusts. On consultation, two thirds of respondents agreed that the general law of fiduciary duties should not be reformed by statute.³
- 11.7 We said that if there were a desire to impose duties on all intermediaries in the investment chain to act fairly, we would need to consider a new statutory cause of action – such as extending rights to sue for breach of statutory duty under section 138D of the Financial Services and Markets Act 2000 (FSMA).
- 11.8 We also note the Government's response to the Kay Review. This implicitly considered that Kay Principles should be achieved through regulation rather than law reform when it asked the FCA to consider to what extent current regulatory rules in this area align with the principle it set out.⁴
- 11.9 Our final view is that the law of fiduciary duties should not be reformed by statute. Instead, if there is a desire to provide investors with greater rights to sue intermediaries for the loss caused by their unfair behaviour, consideration should be given to a new right. Below we consider one possible such right, based on section 138D of FSMA.

AN ALTERNATIVE RIGHT TO SUE: EXTENDING SECTION 138D

- 11.10 Section 138D of FSMA allows a "private person" to sue an intermediary who has caused them loss through a breach of the FCA rules. It states:

A contravention by an authorised person of a rule made by the FCA is actionable at the suit of a private person who suffers loss as a result of the contravention, subject to the defences and other incidents applying to actions for breach of statutory duty.

It operates independently of any other causes of action a claimant may have at common law (for example, a claim in negligence).

³ Out of 62 responses, 42 (68%) agreed that the general law of fiduciary duties should not be reformed by statute, 11 (18%) disagreed and 9 (15%) gave other responses. For further discussion see paras 7.38 to 7.43 above.

⁴ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The Government Response to the Kay Review* (November 2012) para 3.35.

- 11.11 The private person must have suffered loss as a result of the contravention. The law generally requires that a claimant shows that the loss was caused by the breach, that it was reasonably foreseeable, and not too remote. Although these principles are relevant to actions under section 138D, they are applied flexibly. In *Rubenstein v HSBC Bank plc*, Lord Justice Rix said that the approach to causation, foreseeability and remoteness will be “guided by the focus and purpose of the statutory provisions”.⁵ In this way, “whereas the underlying principles may be the same, they may operate in different ways”.⁶
- 11.12 This right, however, is extremely limited. First, the claimant must be “a private person”, as defined in the Right of Action Regulations.⁷ Generally, the claimant must be an individual. Corporate persons may only use this provision if they were not “conducting business of any kind”.⁸ In *Titan Steel Wheels Ltd v Royal Bank of Scotland plc*⁹ the court gave a narrow interpretation to the concept of a private person. A steel manufacturer who had been sold inappropriate swaps by a bank was not able to use section 138D. It was held to be conducting business, even though it was not experienced in financial markets.
- 11.13 Secondly, only some of the rules are actionable.¹⁰ In particular, a private person cannot bring an action on the basis of the FCA Principles for Business,¹¹ even though these are often used as the basis of FCA enforcement. The following Principles, in particular, are highly relevant to the “fiduciary standards” set out in the Kay Review:
- (1) A firm must pay due regard to the interests of its customers and treat them fairly (Principle 6).
 - (2) A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client (Principle 8).
 - (3) A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement (Principle 9).¹²

⁵ *Rubenstein v HSBC Bank plc* [2012] EWCA Civ 1184 at [46].

⁶ Above, at [45], by Rix LJ.

⁷ Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001, SI 2001 No 2256, reg 3.

⁸ Above, reg 3(1)(b).

⁹ [2010] EWHC 211.

¹⁰ The FCA must not have removed the availability of a right of action for the rule in question: Financial Services and Markets Act 2000, s 138D. Among the rules which are not actionable are those in SYSC 10 and the fair, clear and not misleading rule under COBS 4.2.1R if, in relation to a particular communication or financial promotion, a firm takes reasonable steps to ensure it complies with the fair, clear and not misleading rule.

¹¹ FCA Handbook PRIN 3.4.4R

¹² FCA Handbook PRIN 2.1.1R.

What we said in the Consultation Paper

- 11.14 In the Consultation Paper we suggested that section 138D could be extended in two ways. First it could be extended to enable businesses to sue. Secondly, it could be extended to enable actions on the basis of the breaches of the FCA Principles.

Arguments in favour

- 11.15 We thought that this would go a long way towards providing investors with a cause of action for losses caused by breaches of the “fiduciary” standards set out in the Kay Review. In particular, the extended right would allow an investor to sue for loss caused by behaviour which failed to pay due regard to their interests, or which resulted from a conflict of interest. We envisaged a right which could not be excluded by contract.
- 11.16 It would also operate independently of a contractual nexus. In other words, the end-investor would be entitled to sue for losses caused to them by intermediaries higher in the investment chain, even if they did not have a direct contractual relationship with them. As discussed in Chapter 10, an example might be where an investor held shares through an investment platform, who used a custodian to hold legal title to the shares. If the custodian had caused loss to the investor by inappropriate stock lending, the current law may not provide the investor with a direct cause of action against the custodian.
- 11.17 Extending rights to sue would supplement the work of regulators by providing an alternative form of enforcement. Investors could draw attention to issues which the regulator did not have the resources to address. This form of “additional enforcement” could provide a greater deterrent to bad behaviour.

Arguments against

- 11.18 On the other hand, we heard strong arguments against such a change. Increased rights to sue would not necessarily prevent misbehaviour. Civil litigation is inherently uncertain, costly and slow. As we have seen, some cases may take a decade or more to resolve. There is a danger that litigation would introduce greater costs, risks and instability after the event. It may also encourage defensive rather than good behaviour.
- 11.19 The extended rights to sue would not extend the obligations of financial intermediaries: it would only apply where rules had been breached. However, enforcement would no longer be under the regulator’s control. It could operate in new and surprising ways, which could be disruptive.

11.20 The courts are particularly concerned about extending duties to others outside the immediate contractual or trust-based relationship. In *Caparo Industries plc v Dickman*,¹³ Lord Bridge counselled against the creation of “liability in an indeterminate amount for an indeterminate time to an indeterminate class”.¹⁴ Similarly, Lord Oliver was concerned about “a limitless vista of uninsurable risk”.¹⁵ It would not be possible to foresee the full effects of the change, so it might be difficult for insurers to cost the risks involved or provide full cover.

11.21 Our provisional conclusion was that there should be no statutory extension of rights to sue within financial markets. The effect of any such change would be uncertain and potentially disruptive. It would add substantially to costs in the chain, including insurance and legal costs. However, we asked for views on this issue.

Consultees’ views

11.22 The majority of consultees argued against any extension to section 138D of FSMA.¹⁶

Consultees’ views in favour of extension

11.23 The main argument put forward in favour of extending section 138D was that it would improve enforcement. Iain MacNeil explained that it would not extend duties, but only their enforcement:

Regulators do not have the capacity to enforce all breaches of regulatory rules and therefore a supplementary role for private enforcement should be recognized.

11.24 It was argued that this would have beneficial effects on the market by acting as a deterrent to bad behaviour:

While extending the right of litigation may not be a very effective remedy for bad behaviour that has occurred, it has considerable potential as a deterrent, provided that it can be so designed as to minimise the risk of reckless prudence. [Association of Member Nominated Trustees]

Although the right to pursue a claim for such a breach might be difficult because of the general cost of litigation, it might be helpful in some cases. We do not accept that there would be any negative results of adding such a provision. It might actually improve the behaviour of market participants. [ShareSoc]

¹³ [1990] 2 AC 605.

¹⁴ [1990] 2 AC 605 at 621, quoting Cardozo CJ in *Ultramares Corporation v Touche* (1931) 174 NE 441 (NY) at 444.

¹⁵ Above, at 643.

¹⁶ Out of 38 responses, 24 (63%) thought that rights to sue should not be extended, 7 (18%) thought that they should be and 7 (18%) gave other responses.

- 11.25 The Faculty of Advocates thought that it would be particularly beneficial for the end-investors to have a right of action against anyone who had caused them loss:

Given the fragmentation of the investment chain the end investor should have a direct right of action against any party in the investment chain. The end investor ought not to have to concern herself with chain problems.

- 11.26 Iain MacNeil thought that the courts should be more involved in setting standards for the financial sector:

There is also an argument to be made that the courts have for too long been sidelined in setting standards of conduct in the financial sector and that there is no reason in principle why the financial sector should be treated differently from other areas of commerce where the courts are involved in setting fiduciary standards (e.g. agency, partnership, companies).

- 11.27 Charlton Frank argued that problems caused by extending section 138D could be obviated if it was made subject to something akin to a due diligence defence:

Entities other than private persons should be able to sue. Those taking decisions should have nothing to fear if they can demonstrate that the decision was taken after due process and consideration, properly exercising their duty of care.

Consultees' views against extension

- 11.28 Most consultees were against extending rights to sue under section 138D of FSMA. Many felt that the existing position was adequate and that the case for an extension had not been made. As USS Investment Management put it:

We do not believe that an appropriately strong and coherent case has been put forward for extending the right to sue for breach of statutory duty under FSMA.

- 11.29 Investment intermediaries said that any extension would be disruptive and lead to added costs, which would be passed to the ultimate beneficiaries.

Re-fitting the rule-book for the purpose suggested not only would seem a massive endeavour, it likely would create new causes of action not contemplated in existing law, which in turn might introduce significant uncertainty and costs without desired benefits to investors or to the market. [BNY Mellon]

Our view is that the increased litigation risks, and consequential costs, will lead to higher costs being passed down the investment chain, and ultimately to the detriment of beneficiaries. [Association of Consulting Actuaries]

This proposal (if adopted) would create the risk of multiple and/or speculative lawsuits which could place unnecessary costs and risks on service providers and which might lead in turn to more expensive and unnecessarily risk averse services for end investors/pension members. [HSBC Securities Services]

- 11.30 The Investment Management Association thought that it would lead to defensive rather than good behaviour:

We believe that an extension of section 138D would be unhelpful because of the consequences in terms of encouraging overly defensive behaviour and potentially creating additional legal and insurance costs.

- 11.31 Aviva Life & Pensions pointed out that the FCA often took enforcement action against firms for breach of the Principles “and therefore regulated firms can already be held to account as to their overall behaviour”. However, they thought that a requirement to treat customers fairly was subjective: it would create too much uncertainty for firms if they faced action not only from the regulator but also from customers.

A case for further review?

- 11.32 A few consultees thought that the matter required more research and debate before a final view could be reached.

Significant further research and debate would need to be undertaken before reaching a conclusion on this important point. [Commercial Bar Association/Bar Council]

The Forum is of the view that it would be helpful for the Commission’s final report to suggest further consideration of legal rights to redress in its conclusions. [Local Authority Pension Fund Forum]

Conclusion on extending section 138D

- 11.33 There are arguments to be made both for and against an extension of section 138D. We accept that the effects of the change are uncertain. It could be disruptive and add to costs, while encouraging defensive rather than beneficial behaviour. It is also extremely controversial, with most financial intermediaries opposed to the change. We do not feel able to recommend such a change at this stage.

- 11.34 However, we are conscious that the extension might go some way towards implementing the sort of changes envisaged by the Kay Review. Providing a right to sue for a failure to treat customers fairly would underline the importance that the Government attaches to the requirement that all participants in financial markets “should act in the best long-term interests of their clients or beneficiaries”.¹⁷ It is possible that a limited extension, subject to suitable defences, could be implemented without undue costs.
- 11.35 Given the controversy involved, the issue is one for Government. If the Government were sympathetic to this change, we think that the issue would merit further research and debate.

STRENGTHENING FCA RULES

- 11.36 We have not been asked to review the FCA Handbook. That is a mammoth undertaking, which lies outside our expertise and resources. Our project sits alongside Recommendation 7 of the Kay Review that:

Regulatory authorities at EU and domestic level should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions.¹⁸

- 11.37 Nevertheless, this project has emphasised the centrality of FCA regulation. Financial markets cannot function without good regulation. And good regulation often involves finding the right balance between general principles and detailed rules. For all the frustration with a compliance culture, we think that both principle and detail are needed in a system which is to be sufficiently responsive to market change.
- 11.38 In the course of this project we asked stakeholders whether there were any particular areas where FCA rules needed to be revised, either to raise behaviour to fiduciary standards or to encourage a longer-term approach to investment.
- 11.39 Two areas were raised: the regulation of investment consultants and of stock lending. We look at both below. Concerns were also raised about the law underlying the system whereby securities are “owned” through chains of intermediaries, which we consider in the final section.

INVESTMENT CONSULTANTS

What is an investment consultant?

- 11.40 Defined benefit pension schemes rely heavily on investment consultants. Unlike investment managers, consultants do not pick individual investments. Instead they provide strategic advice to trustees about asset allocation.

¹⁷ Department for Business, Innovation and Skills, *Ensuring equity markets support long-term growth: The Government Response to the Kay Review* (November 2012) para 2.8.

¹⁸ J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012) Recommendation 7.

- 11.41 Following the actuarial valuation, trustees will agree a figure on the performance required if the fund is to meet its liabilities. The investment consultant then produces a detailed plan of how to achieve this, focusing on how assets should be allocated between asset classes to provide appropriate levels of yield and risk. The investment consultant's advice will be used to construct one or more mandates, which are the instructions the trustees give to their chosen investment managers. The consultant may also organise a "beauty parade" of the different investment managers the trustees may wish to use.

The role of investment consultants

- 11.42 In theory, consultants merely give advice. In practice, their role appears crucial. Research by Tilba and McNulty found that:

While consultants perceive their role purely as advisory, the trustees for the most part regard consultant's advice to be "*telling*" or directing the trustee as to what investment strategy to pursue.¹⁹

- 11.43 Several consultees confirmed this. Macfarlanes LLP told us that, in practice, most trustees will follow the advice provided by their investment consultants. Aviva Investors identified the "pivotal role" of investment consultants, noting that:

Anecdotal evidence suggests trustee boards comprised of laypersons often lack the skills and experience to critically evaluate and challenge the advice of consultants and often treat them as a layer of indemnity.

- 11.44 In our Consultation Paper we noted that the investment consultancy market was highly concentrated, with three firms dominating the market: Towers Watson, Mercer and Aon Hewitt. It was suggested that this led to many pension schemes being given very similar advice, creating "herding" patterns of investment behaviour.

- 11.45 Investment consultants have been criticised for focusing on short-term returns, rather than a holistic view of factors relevant to investment performance. In his evidence to the BIS Select Committee, Professor Kay said:

We have created this market for investment consultants, who are themselves the source of quite a lot of this short-termist behaviour, because they are typically making recommendations to trustees based on recent performance histories, rather than the future approach and strategy of the manager.²⁰

¹⁹ A Tilba and T McNulty, "Engaged versus disengaged ownership: the case of pension funds in the UK" (2013) 21(2) *Corporate Governance: An International Review* 165 at 173 (emphasis in original).

²⁰ The Kay Review of Equity Markets and Long-Term Decision Making, Third Report of the Select Committee on Business, Innovation and Skills (2013-14) HC 603 at Ev 4.

- 11.46 These concerns are not new. In 2001, the Myners Review found that trustees relied heavily on investment consultants in their asset allocation decisions and in their selection of investment managers, and that they lacked the experience to challenge the advice given.²¹ The review also found that the concentration of the market led to a narrow range of advice with limited innovation.²²

The regulation of investment consultants

- 11.47 It appears that investment consultants do not fall within FCA rules if they only give “generic” advice. This is because investment advice is only a regulated activity under FSMA if it is:

- (1) given to the person in his capacity as investor or potential investor, or in his capacity as agent for an investor or a potential investor; and
- (2) advice on the merits of his buying, selling, subscribing for or underwriting a *particular investment*, or exercising any right conferred by such an investment to buy, sell, subscribe for or underwrite such an investment.²³

These provisions are based on the definition of “investment advice” in MiFID.²⁴

- 11.48 “Advice on the merits” has been construed liberally. In *Martin v Britannia Life*,²⁵ advice had been given to enter into a package of transactions which included a re-mortgage of the claimants’ home. The judge found that advice on the “merits” of an investment included advice about the re-mortgage, as this related to the wider financial context:

The concept of “investment advice” will comprehend all financial advice given to a prospective client with a view to or in connection with the purchase, sale or surrender of an “investment”, including advice as to any associated or ancillary transaction.²⁶

- 11.49 Nonetheless, regulated investment advice must relate to one or more transactions in specific investments, as opposed to generic advice.²⁷ In 2009, the Committee of European Securities Regulators²⁸ published a consultation paper which gave the following examples of generic advice:

- (1) advice on the merits of investing in one geographical zone rather than another;

²¹ P Myners, *Institutional Investment in the United Kingdom: A Review* (March 2001) paras 3.42-3.43.

²² Above, para 4.44.

²³ Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 SI 2001 No 544, art 53 (emphasis added).

²⁴ MiFID, art 4(1)(4); MiFID Level 2, art 52.

²⁵ [1999] All ER (D) 1495.

²⁶ Above, at [5.2.5], by Jonathan Parker J.

²⁷ D Frase, *Law and Regulation of Investment Management* (2nd ed 2011) para 3-026; see also Markets in Financial Instruments Implementing Directive 2006/73/EC, recital 81.

²⁸ The predecessor of the European Securities and Markets Authority.

- (2) advice on the merits of investing in certain asset classes rather than in others;
- (3) advice on different types of investments, for example, whether it would be best for a client to invest directly or through a collective investment scheme; and
- (4) advice to become the client of a particular firm or to use its services in a certain way, provided it does not relate to one or more specific investments.²⁹

11.50 Therefore, it appears that investment consultants do not fall within the scope of FCA regulation so long as they only give advice about, for example, asset classes and geographical zone, rather than about a particular investment.³⁰

Should investment consultants be regulated?

11.51 Stakeholders expressed concern about the apparent lack of regulation of investment consultants. It was said that consultants may experience potential conflicts of interest, which would affect the independence of their advice. For example, advice might be coloured by a particularly close relationship with an investment manager or the presence of an in-house offering.

11.52 Several consultees told us that the lack of regulation for generic advice was anomalous. ShareAction stressed that generic advice was “significantly more critical [than specific advice] to the success of a fund in achieving its objectives”.

Consultees’ views

11.53 In the Consultation Paper we asked if there was a need to review the regulation of investment consultants. The great majority of consultees thought that there was.³¹

Arguments for a review

11.54 The key reason for a review was that the most influential and commonly given advice appeared to be unregulated. The Association of Consulting Actuaries observed that:

Asset allocation decisions have been found to account for a significant proportion of investment returns, over and above manager or fund selection. It is therefore difficult to justify the focus of current regulation where advice on pooled funds is regulated and advice on segregated or directly held investments is considered to be generic advice.

²⁹ Committee of European Securities Regulators, *Understanding the definition of advice under MiFID* CESR/09-665 paras 32 and 39-41. See also FCA Handbook PERG 10.4 Q38.

³⁰ Nevertheless, investment consultancies are often FCA authorised. This is because they may carry out other regulated activities as part of their business, such as arranging deals in investments or advising on the choice of funds.

³¹ Out of 61 responses, 47 (77%) consultees said yes, 6 (10%) said no and 8 (13%) gave other responses.

11.55 A similar view was taken by the Association of British Insurers (ABI):

Investment consultants play an important role in advising asset owners on key asset allocation and investment decisions. Given their influence on the functioning of the investment chain of intermediation and the apparent lack of clarity on their legal and regulatory position, we believe it would be appropriate to consider their role more closely.

11.56 The ABI also commented that as the regulatory system requires investment consultants to concentrate on “generic” advice, this might discourage investment consultants from giving more specific or tailored advice where it was needed:

Where herding of strategies may occur, it is mainly as a result of an industry structure in which pension schemes rely on the generic advice of a small number of investment consultants and where investment managers are judged in relation to a benchmark of other investment managers, as identified in the consultation paper. The need for investment consultants to provide “generic” advice to remain unregulated would appear to exacerbate this situation, in the sense that a narrow interpretation of the law may support a business model that needs to provide more standardised or “generic” advice.

11.57 Two investment consultants responded to our consultation. Towers Watson was in favour of a review while Mercer disagreed. Towers Watson said:

The regulation of investment consultants now seems somewhat dated, with advice on the provision of pooled vehicles regulated, unlike similar advice on segregated portfolios. Furthermore, advice on portfolio strategy can have a more profound impact on a scheme's finances than advice on manager selection, yet it does not need to be provided by a regulated advisor. In order to help all trust-based pension funds to get a minimum standard of advice in these matters, we would advocate that such advice be regulated.

Arguments against a review

11.58 Mercer noted that although the provision of generic advice was not regulated by the FCA, investment consultants nonetheless owed a duty of care to their clients in respect of all advice. Mercer also stressed the benefits of generic advice remaining unregulated, as it meant that it could be given by a wide range of different organisations:

Currently the lack of regulation of generic advice in theory allows trustees to seek “advice” from a wide base of professionals including independent experts, their actuary and their investment managers. The ability to “canvas” a variety of sources is probably of advantage when seeking information and guidance on investment strategy matters.

11.59 Richard Nobbs also noted that, given that many investment consultants were already regulated (such as IFAs) or acted as professionals in large consultancies, additional regulatory requirements were unlikely to have much impact.

Conclusion

- 11.60 It is important that investors are able to obtain advice easily and cheaply. Increasing the scope of regulation in such a way that makes this more difficult is likely to be detrimental for both investors and financial markets generally. Many investment consultants are already regulated in respect of other services that they provide, and will in any event owe duties of care in respect of all advice they give.
- 11.61 There is also limited scope for the rules relating to “generic advice” to be reformed. The regulatory definition of investment advice implements the provisions of the Markets in Financial Instruments Directive (MiFID), and the Directive states that member states are only permitted to add to its requirements:

in those exceptional cases where such requirements are objectively justified and proportionate so as to address specific risks to investor protection or to market integrity that are not adequately addressed by this Directive.³²

In addition, the additional requirements must meet one of the following requirements:

- (1) the specific risks addressed by the requirements must be of particular importance in the circumstances of the market structure of that member state; or
 - (2) the requirement addresses risks or issues that emerge or become evident after the date of application of the Directive and that are not otherwise regulated by or under EU measures.
- 11.62 Following consultation, we do not think that the MiFID hurdle has been met: consultees have not identified a specific risk which would objectively justify extending regulation in this area. However, the lack of regulation of investment consultants does appear anomalous, and we would ask that the Government actively monitor this area. One possibility would be for the Government to commission independent research into the issues raised by the current regulation of investment consultants. If specific risks become apparent, further regulation would be justified.

STOCK LENDING

- 11.63 As we noted in our Consultation Paper, the main controversy affecting custodians relates to stock lending (also commonly known as securities lending).³³ Below we outline how stock lending works, the concerns that have been raised about it, and how it is regulated. We then discuss consultees’ views on whether there is a need to review the regulation of stock lending.

³² MiFID Level 2, art 4(1).

³³ Custodians are the most commonly appointed agents but in some cases investment managers or specialist firms may undertake stock lending.

How does stock lending work?

- 11.64 In stock lending, the custodian “lends” the investments it holds for its clients to borrowers who wish to “short sell” the shares or other securities.³⁴ In other words, the borrower seeks to profit from a fall in their price by borrowing and selling them, hoping later to buy them back at a lower price and return them to the lender.³⁵ The custodian takes collateral in case the borrower defaults and receives a fee, which may be passed on (in whole or in part) to its client.
- 11.65 The practice of stock lending is often expressly authorised by the contract between the custodian and its client (such as a pension scheme or insurance company). These agreements outline how any income derived from stock lending will be divided between the parties, and how the collateral received by the custodian will be invested. A recent case explained that it is now common for collateral to be in cash, and the profits derived from stock lending depend on how this cash is invested:
- It is clear from the evidence that cash collateral is much more common, largely because it can be reinvested at a profit. Where a securities loan is made against cash collateral, the lender of the securities pays interest to the borrower. This will typically exceed the lending fee paid by the borrower, meaning that there is a net amount (or “rebate”) due from the lender to the borrower. This means that in order to make a profit, the lender must invest the cash collateral at a return greater than the rebate.³⁶
- 11.66 Stock lending involves risks. First, the borrower may default, and the collateral may prove insufficient. Secondly, losses may be caused by the way that cash collateral has been invested. These risks are typically borne by the client. Our understanding is that, to guard against these risks, cash collateral is often invested in money market funds.³⁷ The FCA Handbook contains specific restrictions on how collateral may be invested.³⁸
- 11.67 The borrower is obliged to return the securities to the custodian, either on demand or at the end of the term over which they were lent. In addition, if the shares or bonds pay dividends or coupons while they are out on loan, the borrower may be obliged to pay to the custodian the amount it would have received had the securities not been lent.

³⁴ Strictly speaking, stock that is “lent” is transferred outright from the lender to the borrower. The borrower is contractually obliged to return the securities on demand within the standard market settlement period, or at the end of the term over which they were lent.

³⁵ The borrower may not necessarily return the “same” securities. Instead, the borrower may return securities of the same type and amount.

³⁶ *Första AP-Fonden v Bank of New York Mellon* [2013] EWHC 3127 (Comm) at [40].

³⁷ These are funds which invest in money market instruments such as certificates of deposit, commercial paper and Treasury bills.

³⁸ FCA Handbook COLL 5.4.8G(2). These rules only apply to authorised funds.

Concerns about stock lending

11.68 At a purist level, stock lending introduces a conflict of interest into the system. This can be illustrated with an example. A pension fund holds shares for the long-term, with the intention of encouraging the long-term sustainability of the company. It gives its shares to a custodian for safe-keeping, who then lends the shares to a speculator with a financial interest in the company's failure. The interests of the pension fund and the speculator clearly diverge.

11.69 Despite this potential conflict, stock lending has become a central part of the way that capital markets work. Paul Tucker, Deputy Governor of the Bank of England, put it in the following terms:

Securities lending is essential for any capital market to work efficiently. Liquidity requires market makers or traders who willingly incur short positions to meet buyers' orders. They will do so only if they can cover their short positions - meaning that they need to be able to borrow securities to deliver into their sold positions. That in turn requires investors in those securities to be willing to lend them.³⁹

11.70 Professor Kay noted that "short selling is, at first sight, incompatible with the concept of stewardship", as it implies a lack of trust in the management of the company whose shares are sold. However, he thought that short sellers may have some useful function in exposing poor management:

Many of the most publicised cases of short selling have been instances in which managers had proved poor or even corrupt stewards of corporate assets and that the activities of short sellers had sometimes been a means of value discovery in the face of attempts by management to mislead investors.⁴⁰

11.71 Professor Kay thought that short selling could be damaging if it went too far, but that position had not yet been reached:

Short selling could reach volumes in which the activity is self-reinforcing and damaging to the interests of sound companies. While this eventuality, which could profoundly damage long-term decision making, is certainly a possibility, we received little evidence that such a position had yet been reached.⁴¹

11.72 He noted that some respondents thought that investors who were long in a stock, and who acknowledge stewardship responsibilities, should not encourage short selling by making their stock available for stock lending. He did not share this view.⁴²

³⁹ Speech by Paul Tucker at the Association of British Insurers (13 March 2012). Available at <http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech551.pdf>.

⁴⁰ J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012) para 9.23.

⁴¹ Above, para 9.24.

⁴² Above, para 9.25.

11.73 However, Professor Kay felt strongly that “all income from stock lending should be disclosed and rebated to investors”.⁴³ If custodians were allowed to keep the fees, while the savers bore the risks, there would be inappropriate incentives to lend stock, which could distort the market. He said:

The risks associated with stock lending ... remain with the fund whose stock is lent (and hence with the saver). There is therefore a divergence between the recipient of the income and the bearer of the risk for which the income is compensation. Such a divergence may distort competition and give an artificial, and inappropriate, incentive to engage in stock lending. More broadly, such divergence is inconsistent with fiduciary principles.⁴⁴

The regulation of stock lending

11.74 Stock lending is regulated by the FCA. The rules are complex and many apply only to stock lending arrangements entered into by a fund. Below we discuss how the rules apply when funds enter into stock lending arrangements. We then consider how they apply where the trustees of a pension scheme enter into arrangements directly with a custodian.

Stock lending by funds

11.75 FCA rules allow stock lending by funds where it appears to the fund to be appropriate to do so with a view to generating additional income for the fund with an acceptable degree of risk.⁴⁵

11.76 The rules govern the form stock lending arrangements must take.⁴⁶ Broadly, they require that:

- (1) the terms of the agreement must accord with good market practice;
- (2) the counterparty must be an authorised person (or one of several other designated entities); and
- (3) adequate collateral must be obtained. It must be at least equal to the value of the securities at the time of the transfer, and must be reasonably liquid.⁴⁷

⁴³ J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012) Recommendation 10.

⁴⁴ Above, para 9.25.

⁴⁵ FCA Handbook COLL 5.4.3R.

⁴⁶ FCA Handbook COLL 5.4.4.R.

⁴⁷ For example, cash or a readily realisable security: see FCA Handbook COLL 5.4.6R(1)(c).

11.77 There is no limit on the proportion of the fund's assets which may be the subject of a stock lending agreement.⁴⁸ However, guidance in the FCA Handbook suggests that:

The use of stock lending or the reinvestment of cash collateral should not result in a change of the scheme's declared investment objectives or add substantial supplementary risks to the scheme's risk profile.⁴⁹

11.78 There are also some requirements that income acquired from stock lending be passed to the investor. Since 2013, guidelines from the European Securities and Markets Authority (ESMA) required that UCITS⁵⁰ investment managers should return all stock lending revenues to investors, "net of direct and indirect operational costs".⁵¹

11.79 In the Consultation Paper we said that the guidelines suffered from weaknesses. They only apply to investment managers of collective investment schemes which are authorised under the UCITS Directive. Furthermore, they fail to define "an indirect operational cost". This allows investment managers to interpret the guidelines creatively, retaining fees to offset against a range of costs. It has been suggested that "asset managers have been reluctant to overhaul their current securities lending practices since the new rules were announced".⁵²

11.80 The FCA's prudential rules for insurers (INSPRU) also address this issue where insurers offer customers the opportunity to invest in unit-linked funds⁵³ (often as part of a contract-based pension). In its recent thematic review of unit-linked funds, the FCA noted that:

Although legally the assets lent belong to the insurer, they have been purchased with money provided by customers and, therefore, those customers are entitled to a fair share of the stock lending revenues and to be reasonably protected from the risks involved.⁵⁴

⁴⁸ FCA Handbook COLL 5.4.7R.

⁴⁹ FCA Handbook COLL 5.4.8G.

⁵⁰ UCITS stands for Undertakings for Collective Investment in Transferable Securities. A UCITS is an open-ended collective investment vehicle which complies with the requirements of the UCITS IV Directive 2009/65/EC, Official Journal L 302 of 17.11.2009 p 32. These are schemes which may be marketed to members of the general public across the EU.

⁵¹ European Securities and Markets Authority, *Guidelines for competent authorities and UCITS management companies* (2012), available at http://www.esma.europa.eu/system/files/2012-832en_guidelines_on_etfs_and_other_ucits_issues.pdf.

⁵² D Ricketts, "ESMA adds guidance, but not clarity, on securities lending" (21 March 2013) *Financial Times/Ignites Europe*.

⁵³ For an explanation of unit-linked funds, see paras 8.21 to 8.22 above.

⁵⁴ Financial Conduct Authority, *The governance of unit-linked funds* (October 2013) TR 13/8 para 2.3.3.

The review concluded that “most firms allocated a fair share of revenues from stock lending to the fund”.⁵⁵

11.81 Broadly speaking, the INSPRU rules require that:

- (1) if the customers’ fund bears any risk, the extent of this must be disclosed to them;
- (2) if the fund bears the risk, then the fund should receive all recompense (less fees and expenses); and
- (3) if the risk is borne outside the fund (for example, by the firm), then the fund should receive “fair and reasonable” recompense.⁵⁶

Stock lending by trustees

11.82 The assets of trust-based pensions are often held by a custodian. FCA rules prohibit custodians from entering into stock lending transactions in respect of such assets unless:

- (1) the client has given express prior consent to the use of the assets on specified terms; and
- (2) the use of that client’s assets is restricted to the specified terms to which the client consents.⁵⁷

11.83 In practice, pension trustees will often permit their custodians to engage in stock lending as a way of generating additional returns. Such arrangements will be subject to a separate “securities lending agreement”, which will detail the terms on which the custodian may lend and how any profit is to be distributed between the parties.

Is there a need to review the regulation of stock lending?

11.84 In our initial discussions, stakeholders raised concerns that investors were bearing the risks of stock lending without reaping all the benefits. Although stock-lending was authorised in contract terms, it was said that pension trustees were often unaware of these terms. They may be unaware that they were bearing all the risk in return for only a proportion of the returns.

11.85 In our Consultation Paper, we asked whether consultees thought there was a need to review the regulation of stock lending. The majority of consultees thought that there was.⁵⁸

⁵⁵ Above.

⁵⁶ See FCA Handbook INSPRU 3.2.36R-3.2.42G; Financial Conduct Authority, *The governance of unit-linked funds* (October 2013) TR 13/8 para 2.3.3.

⁵⁷ FCA Handbook CASS 6.4.1R.

⁵⁸ Out of 47 responses, 30 (64%) said yes, 12 (26%) said no and 5 (11%) gave other responses.

Arguments in favour of a review

- 11.86 Two main criticisms were made of stock lending. The first was that stock lending is inconsistent with the best interests of the end-investor. The Commercial Bar Association/Bar Council response put the point strongly:

To an industry-outsider, and lawyer, stock-lending by custodians seems little short of scandalous. The idea that a custodian should be gambling the very assets which are entrusted to its safekeeping, for its own private profit, must be outlawed unless there are compelling reasons justifying its continuance, in which case the profit should be, at the very least, shared.

- 11.87 Ben Rudder said that it “creates even more confusion about legal ownership and where the governance obligations of assets lie” and therefore “it should be more tightly regulated and possibly outlawed”.

- 11.88 Hermes Equity Ownership Services argued that:

When abused it can be used as a highly predatory and short-term tool for influence which can be detrimental to the long-termism and stewardship agendas. For example, short term borrowers of stock from custodians may exercise their voting rights and exert influence in a way that is inconsistent with the interests of long term shareholders.

- 11.89 UKSIF argued that it is a potential contributor to short-termism and volatility.

- 11.90 The second argument was that end-investors are bearing a risk, for which they are only partially compensated (if at all). Margarita Sweeney-Baird argued that:

There should be recognition that the pension beneficiaries who bear the risk of loss should expressly authorise this practice and should where permitted obtain the benefit of any profits so made. Further, stock lending if allowed should be clearly regulated and be a matter for the compliance auditor to investigate and report upon.

- 11.91 Magda Raczynska and Duncan Sheehan argued that “a more restrictive approach is needed, perhaps one where passing profit to members is mandatory”.

Arguments against a review

- 11.92 Those consultees who were not in favour of a review stressed the benefits of stock lending to the end-investor.

- 11.93 Mercer said it was broadly supportive of asset owners who wished to engage in stock lending, and that, provided sufficient care was taken in arranging collateral and contractual protections, stock lending could provide additional revenue within “reasonable risk parameters”. They criticised our narrow characterisation of stock lending, noting that this:

unfairly characterises the function and results in an undeserved negative perception of the activity.

11.94 Mercer suggested that “stock lending arrangements negotiated by fund promoters are less commercially satisfactory than those arrangements directly negotiated by asset owners”. They argued that this is particularly problematic “in the collective investment sector, especially where the fund promoter and agent lender are part of the same financial group”.

11.95 The custodians who responded to our consultation also stressed the benefits of stock lending to their clients. HSBC Securities Services said that Professor Kay had failed to take into account that stock lending could enhance the client's returns on its custodial assets (since it would retain the bulk of the stock lending fees which are generated in this way). They told us that their clients typically receive 75-85% of fees paid by borrowers. They also told us that the risks faced by their clients were significantly mitigated by:

careful selection of stock borrowers, the taking of investment grade bonds and liquid equity collateral and by the fact that the custodian will usually indemnify the client for certain losses it may suffer by lending its assets.

HSBC Securities Services added that clients always have a choice as to whether to use stock lending facilities, and that changes in regulation could lead to business migrating out of the UK without any consequential increase in investor protection.

11.96 We received a detailed response from the International Securities Lending Association (ISLA), the industry representative body for the securities lending market in Europe. They took the view that stock lending was a discretionary activity which certain clients opted into in order to generate incremental returns. In their response to the Kay Review, ISLA estimated that long-term institutional investors such as pension funds earned over €1 billion per annum from stock lending.⁵⁹ They added that it was important that pension trustees undertake due diligence before entering into such arrangements. Finally, ISLA said that they had prepared publications designed to explain the risks as well as the benefits of stock lending, and to provide trustees with a checklist of key questions that should be considered.

⁵⁹ This figure is for European beneficial owners such as pension funds, insurance companies and other long term investors: see http://www.isla.co.uk/images/PDF/Publications/KayReview_Response_27Apr12.pdf.

- 11.97 The Society of Pension Consultants thought that stock lending was a matter to be resolved between the client and their custodian, noting that:

It is our experience that, where a custodian acts as a lending agent for an asset owner, it will do so under a securities lending agreement negotiated directly between the agent and asset owner. As such, the terms of the lending programme are explicitly agreed with the asset owner, including the revenue splits. We do not feel it necessary for regulation to interfere with such contractual agreements, on the basis that such agreements should only be entered into by informed market participants. We suggest that FCA's attention would be better directed to affiliated lending agents, who are generally not explicitly appointed by the beneficial asset owners and which have potential conflicts of interest which need to be managed.

- 11.98 Several of the consultees who spoke in favour of stock lending as a practice nevertheless favoured transparency. The Institute and Faculty of Actuaries told us that:

We support transparency in investment markets - revenue disclosure should be required as a matter of course. However, we are not convinced that a full rebate is the best solution - revenue sharing is a common and in our view reasonable approach. The commercial terms are arguably best left to market participants rather than being subject to regulation, unless there is evidence of market failure, which does not appear to be the case.

Conclusion

- 11.99 Stock lending is clearly a controversial area. On one hand, it provides market intermediaries with liquidity and can provide a useful supplement to investors' returns. On the other hand, it has risks which may not be fully transparent to the end-investor.
- 11.100 Regulations apply to unit-linked funds and to UCITS schemes, which are the funds most commonly sold to retail investors. The regulations require that the end-investor receives the benefit of stock lending "less fees and expenses" (or, as ESMA puts it, "net of direct and indirect operational costs"). Here the devil is in the detail: what is a reasonable fee for stock lending, and what counts as a legitimate expense?
- 11.101 Under the new approach to pension costs and charges described in Chapter 9, trustees and independent governance committees (IGCs) will be expected to answer these questions. This will be a difficult task. As we say in Chapter 9,⁶⁰ trustees and IGC members will need to be given training and support on this issue. We think that there will also need to be some central source of information, tracking what level of fees might represent good value for money.

⁶⁰ See para 9.84 above.

- 11.102 Outside these particular funds, there is no requirement that stock lending fees are rebated. So, for example, pension trustees who hold their own share portfolio need to negotiate their own arrangements with their custodians. At first sight, this lack of regulation appears to be a problem. However, we have been told that the revenue splits commonly negotiated with pension trustees may often be more advantageous to the investor than the “rebate less fees and expenses” arrangements in unit-linked funds. There may be little benefit in simply extending the unit-linked funds or UCITS requirements more widely. Instead, it is important that pension funds have sufficient scale and that pension trustees have sufficient sophistication to understand the need to negotiate in this area.
- 11.103 We do not recommend another review of stock lending at this stage. The emphasis must be on making the amount of stock lending fees retained by the intermediary more transparent, under the Government’s commitment to ensure the transparency of all pension costs described in Chapter 9.
- 11.104 Instead, we think that stock lending fees should be considered at the same time as the review of the default fund charge cap in April 2017. It will need to consider what risks are being taken, whether adequate disclosure is being made, and whether there are any new requirements for transparency or controls in this area. We hope that trustees and IGCs will be able to provide evidence about the stock lending fees and expenses which are charged to pension schemes, and whether further controls are needed.

THE LAW OF INTERMEDIATED SECURITIES

- 11.105 Finally, we consider the system by which investors hold shares and other securities. We begin with a short description of recent changes, as paper shares have largely been replaced by “intermediated” and “dematerialised” accounts. We summarise the main legal principles which apply to this system, and list the problems with the law. We then report consultees’ views and reach a conclusion.

The way that securities are held

- 11.106 The system by which investors own stocks and shares has evolved dramatically in recent years. Traditionally, shareholders held shares directly from the company, either because they were registered in the company’s books, or because they held paper certificates.⁶¹

⁶¹ In the case of “bearer” securities, the paper document legally constitutes the securities and the rights that they embody. Delivery of the document is sufficient to transfer ownership of the bearer securities.

11.107 A paper-based system is costly and inefficient, and vulnerable to theft or forgery. By the 1980s, it was struggling to cope with the rising volume of transactions. In 1989, the Group of Thirty identified two mechanisms by which a computerised regime could replace paper.⁶² These were “dematerialisation” and “immobilisation”:

- (1) “*Dematerialisation*” means that companies can issue securities without any paper certificate to constitute or evidence them.⁶³ A dematerialised security (also known as an “uncertificated security”) is represented instead by an entry in an electronic register and is transferred by amending the register.
- (2) “*Immobilisation*” entails placing securities in paper form in a central depository.⁶⁴ Where a new issue of securities is immobilised from the outset, the entire issue will be typically constituted by a single “global” or “jumbo” certificate which remains in the vaults of the depository. The depository (or its nominee) becomes the owner of the securities and all other investors then hold through that depository.

A chain of intermediated holdings

11.108 As long as securities are immobilised in the form of a global certificate, investors are obliged to hold securities indirectly, either through a central depository or through an account holder of the depository.⁶⁵ As we explain below, this has led to the “intermediation” of securities holdings.

⁶² The Group of Thirty, *Clearance and Settlement in the World’s Securities Markets* (1989). The Group of Thirty is a leading consultative group on international economic and monetary affairs.

⁶³ The Group of Thirty Report *Clearance and Settlement in the World’s Securities Markets* defines dematerialisation as “the elimination of physical certificates or documents of title which represent ownership of securities so that securities exist only as computer records”.

⁶⁴ The Group of Thirty Report *Clearance and Settlement in the World’s Securities Markets* defines immobilisation as “the storage of securities certificates in a vault in order to eliminate physical movement of certificates/documents on transfer of ownership”.

⁶⁵ As Russell Hakes observes in connection with the US securities markets: “With indirect holding, an investor does not make a trade without coming back to the broker through whom it indirectly holds the security.” See R Hakes, “UCC Article 8: Will the indirect holding of securities survive the light of day” (2002) 35 *Loyola of Los Angeles Law Review* 669.

- 11.109 Most advanced economies rely on a Central Securities Depository (CSD) to hold physical and dematerialised securities.⁶⁶ Typically, a CSD is the first holder in a chain. It holds on behalf of its “account holders”,⁶⁷ who may be banks, corporations or foreign CSDs. These account holders may in turn hold some or all of their securities on behalf of their own customers, who form a third tier. These third tier customers may, in turn, hold on behalf of their own account holders, leading to what may be a long chain of intermediaries between the issuing company and the end-investor. A result of this structure is that only the CSD has a direct relationship with the issuer of the securities. All other interests derive from the credit of securities to a securities account, each account holder's relationship being with its own intermediary.⁶⁸
- 11.110 The UK does not operate a centralised depository in quite this way. Instead, CREST is the main securities settlement system in the UK and it settles securities in uncertificated form. Unlike system operators in most national settlement systems, CREST has no proprietary rights in domestically issued securities.⁶⁹ It is not treated as “holding” these securities from the issuer on behalf of its participants. Rather, CREST operates a register, which confers legal title on the person or entity named in the register. Each member on the CREST register holds directly from the issuer, and is treated as the shareholder for company law purposes. The CREST member alone is entitled to exercise voting, dividend and other rights attaching to the shares and may do so directly against the issuer.
- 11.111 Securities holdings in the UK are also highly intermediated. CREST members are often custodians, and they may pool securities held by them for various intermediaries in a single account. Typically, where a pension trust (for example) owns shares, it needs only to have its name entered onto the computer system of one intermediary in the chain.

The legal principles

- 11.112 There has in the past been some debate over the legal relationship that governs this ownership structure. It might be viewed as either a back-to-back chain of creditor-debtor relationships, or as a series of trusts, where each tier holds an interest for the benefit of those in the tier below.⁷⁰ We now think that it generally operates as a series of trusts.

⁶⁶ In America, the Depository Trust and Clearing Corporation (DTCC) has custody, through its nominee Cede & Co, of 90% of all US securities valued at \$33.9 trillion: see http://www.dtcc.com/~media/Files/Downloads/Settlement-Asset-Services/Issuer%20Services/Issuer_Serv_Brochure.ashx.

⁶⁷ “Account holder” means any party that holds intermediated securities through a credit in the account of its intermediary. This may include an account holder that is itself holding as intermediary on behalf of its own account holders. An “investor” refers to an account holder that is not acting as an intermediary in respect of the securities and is therefore ultimately entitled to the benefits derived from them.

⁶⁸ Financial Markets Law Committee, *Issue 3 – Property Interests in Investment Securities* (July 2004) para 2.2.

⁶⁹ That is, in the UK, Republic of Ireland, Isle of Man, Guernsey and Jersey.

⁷⁰ See R McCormick, *Legal Risk in the Financial Markets* (1st ed 2006) at paras 7.17-7.40; M Yates and G Montagu, *The Law of Global Custody* (4th ed 2013) at paras 5.62-5.67.

A series of trusts

- 11.113 In 2008, the Law Commission published Advice to HM Treasury on this issue. We concluded that, in the great majority of cases, each investor held a beneficial interest under a trust.⁷¹

If, as may often be the case, the securities are held through a chain of intermediaries, the highest tier intermediary will hold the legal title to the underlying securities with the intermediary directly below it holding an equitable interest in them. The conclusion generally drawn from this analysis is that each lower tier intermediary will hold its equitable interest as sub-trustee on sub-trust for the intermediary below it and so on down to the investor at the bottom of the chain. Consequently, the bundle of rights and interests held by the investor (and by each lower tier intermediary) represent equitable rights and interests that are derived through a series of sub-trusts from the underlying securities.⁷²

- 11.114 The advantage of a trust arrangement is that an investor is protected should the intermediary become insolvent. Any securities held for the intermediary's clients would not be available to the intermediary's creditors.

“No look-through”: enforcement through each link of the chain

- 11.115 Under English trust law, an account holder as beneficiary will not have the right to enforce the terms of the securities against the issuer directly.⁷³ Instead, each beneficiary must enforce its rights against its own intermediary, who must in turn enforce against the next tier in the chain.

⁷¹ Exceptionally, an investor will have legal title and therefore direct rights against the issuer under English law if the intermediary holds bearer securities as bailee. However, the structure of intermediated custody is incompatible with bailment, as intangible assets (such as computerised registered securities) cannot be the subject of bailment. See M Yates and G Montagu, *The Law of Global Custody* (4th ed 2013) paras 2.35, 3.10-3.15; A Austen-Peters, *Custody of Investments: Law and Practice* (2000) paras 2.28-2.29. For the Law Commission's analysis of the law in this area, see Law Commission, *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Further Updated Advice to HM Treasury* (May 2008). See also R McCormick, *Legal Risk in the Financial Markets* (1st ed 2006) at paras 7.17-7.40; M Yates and G Montagu, *The Law of Global Custody* (4th ed 2013) at paras 5.62-5.67. For the position in Scots law, under which the custodian who requires title to be transferred is seen as indistinguishable from a nominee and so probably a trustee, see Supplementary and Miscellaneous Issues in the Law of Trusts (2011) Scottish Law Commission Discussion Paper No 148 para 5.13.

⁷² Law Commission, *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Further Updated Advice to HM Treasury* (May 2008) para 5.41. While in Scots law beneficial interests are personal rights, that does not prevent this sort of multi-tier set-up from being legally effective.

⁷³ Unless the issuer permits otherwise by contract or provisions in a deed poll or trust deed.

- 11.116 This is referred to as the “no-look-through” principle. The Financial Markets Law Committee has explained that:

The no-look-through principle is dictated as much by practicalities as by concerns for market efficiency. It might be thought relatively easy to show the chain of title between issuer and ultimate investor. In practice, it may be difficult, if not impossible, to trace through the chain of intermediaries from which the ultimate investor acquired his interest.⁷⁴

- 11.117 This means that if a company defaults on its obligations to its shareholders, the account holder may not be able to sue directly. Nor will the account holder’s intermediary be liable for the default. The account holder must rely on the intermediary to take action, in accordance with its duties under trust law and the terms of the account agreement. This could involve suing the issuer or participating as a creditor in the issuer’s insolvency. If the intermediary does not hold directly from the issuer but through a higher tier intermediary, it can enforce its rights on behalf of the investor only by enforcing its rights against the intermediary above it.

Dividends and voting

- 11.118 The account holder’s ability to receive the benefit of the security is set out in the account agreement, which in legal terms operates as the trust instrument. The agreement will ordinarily require the intermediary to collect and distribute to its account holders the economic benefits that it receives, such as dividends or interest. It may also, but not always, require the intermediary to exercise voting and other discretionary rights in accordance with the express wishes of the account holder.

Problems with the law

- 11.119 We have identified four problems with the law in this area: legal uncertainty; investors’ difficulties in exercising rights; lack of transparency; and potential risks. Ideally, these problems would be addressed at an international level. However, as we explore below, international initiatives in this area have floundered.

⁷⁴ Financial Markets Law Committee, *Issue 3 – Property Interests in Investment Securities* (July 2004) para 6.5.

Legal uncertainty

11.120 The first problem is that the law may have been left behind by the speed of recent changes. The law of intermediated securities has not been written down and it is not wholly certain. The Financial Markets Law Committee has noted that:

These ... operational changes ... facilitate rapid dealings in the international securities markets. However, the same changes take practice beyond the scope of settled law. Many rules of law relevant to the securities markets were developed in relation to traditional, paper-based practice. Their application in the new environment is in a number of respects both uncertain and unsatisfactory. This is a source of legal risk, including in particular systemic risk, and is also inimical to the efficient functioning of the market.⁷⁵

11.121 A leading textbook notes that a major source of legal risk in this area is “legal anachronism”.⁷⁶

11.122 An example of such an “anachronism” is the operation of section 53(1)(c) of the Law of Property Act 1925 in this context. Under this section, a transfer of an equitable interest (which an intermediary’s client has) must be transferred by a written instrument. This does not reflect the practice of the market when settling computerised securities. Whilst this section does not apply to transfers through CREST,⁷⁷ it does apply to “internal” transfers (transfers settled across the books of a custodian).⁷⁸ The Financial Markets Law Committee has observed that although legal arguments can be found to address this problem:

the reasoning is invariably complex and the parties may not always wish to take the time (or expense) to do so, thus leaving potential risks lurking in the markets.⁷⁹

Difficulties in exercising rights

11.123 The second problem is more practical. Investors may find it difficult to exercise their voting and other rights with respect to the company. We have been told that the practice of holding shares in nominee accounts leads to investors being deprived of the rights that attach to those shares.

⁷⁵ Financial Markets Law Committee, *Issue 3 – Property Interests in Investment Securities* (July 2004) para 1.2.

⁷⁶ M Yates and G Montagu, *The Law of Global Custody* (4th ed 2013) para 1.13.

⁷⁷ Uncertificated Securities Regulations 2001 SI 2001 No 3755, reg 38(5). This disapplication does not extend to transfers of interests in securities which a person has as a result of holding through a custodian or nominee which is a CREST member.

⁷⁸ There is legislative power to disapply provisions such as section 53(1)(c) under section 8 of the Electronic Communications Act 2000. Such disapplications could be made in favour of electronic securities settlement: M Yates and G Montagu, *The Law of Global Custody* (4th ed 2013) para 2.31.

⁷⁹ Financial Markets Law Committee, *Issue 3 – Property Interests in Investment Securities* (July 2004) para 6.9. For a discussion of possible legal analyses, see Law Commission, *Third Seminar: Issues affecting Transferees of Intermediated Securities* (July 2006) paras 1.27-1.45, available at http://lawcommission.justice.gov.uk/docs/Intermediated_security_seminar_3.pdf.

11.124 In February 2013, the Cox Review noted that:

The ultimate shareholder, the individual saver or pension holder, is a long way removed from the company on whose growth his or her prosperity ultimately depends. The individual may well have a long-term interest, but that is not served by the cumulative behaviour of all the participants in the chain.⁸⁰

11.125 The case of *Eckerle v Wickeder Westfalenstahl GmbH* illustrates the problem.⁸¹ The claimants sought to bring an action against the company for relief under section 98 of the Companies Act 2006.⁸² To succeed in their claim, the claimants had to show that they were “the holders” of a certain number of shares in a company, DNick. They failed to do this.

11.126 On the facts, all but one of the 5,671,318 issued ordinary shares in DNick were registered in the name of Bank of New York Depository (Nominees) Ltd (“BNY”). BNY held these shares on trust for account holders of the Clearstream settlement system. Mr Justice Norris held that “the holders” of a company’s issued shares were those who were registered as holding them, not the investors who owned the ultimate economic interest in the shares.⁸³

11.127 Some of these difficulties may be addressed by the proposed revision to the Shareholder Rights Directive.⁸⁴ Under the proposals outlined by the European Commission in April 2014, member states will be required to ensure that intermediaries offer to companies the possibility of having their shareholders identified and that intermediaries provide, on request by a company, the details of the company’s shareholders.⁸⁵ Intermediaries will also be obliged to transmit information to shareholders,⁸⁶ and to facilitate the exercise of their rights, including “the right to participate and vote in general meetings”.⁸⁷

Lack of transparency

11.128 Thirdly, the system leads to a lack of transparency over who ultimately owns the shares.

⁸⁰ Sir George Cox, *Overcoming short-termism within British business: The key to sustained economic growth* (February 2013) pp 20-21.

⁸¹ *Eckerle and Ors v Wickeder Westfalenstahl GmbH, Dnick Holding plc* [2013] EWHC 68 (Ch).

⁸² Where a special resolution by a public company to be re-registered as a private limited company has been passed, section 98(1)(a) of the Companies Act 2006 allows the “holders” of not less in the aggregate than 5% in nominal value of the company’s issued share capital or any class of the company’s issued share capital (disregarding any shares held by the company as treasury shares) to bring an application to the court for the cancellation of the resolution.

⁸³ [2013] EWHC 68 (Ch) at [18].

⁸⁴ Directive 2007/36/EC, Official Journal L 184 of 14.07.2007, p 17.

⁸⁵ Proposal for the revision of the Shareholder Rights Directive COM(2014) 213 final, art 3a.

⁸⁶ Above, art 3b.

⁸⁷ Above, art 3c.

- 11.129 The EU 4th Anti-Money Laundering Directive, which is currently being debated by the European Parliament, addresses some of these concerns. It proposes a public central register in each EU member state to list information on the ultimate beneficial owners of companies and trusts. The Government has also proposed to introduce a central registry of company beneficial ownership information.⁸⁸
- 11.130 However, these initiatives are unlikely to be effective in improving the transparency of the equity investment chain. Rather, they address the misuse of corporate structures. Moreover, both proposals are limited in scope: the definition of “beneficial ownership” they adopt means that only information on individuals who ultimately own or control more than 25% of a company’s shares or voting rights, or who otherwise exercise control over a company or its management, will need to be obtained and held by the company and provided to the central registry. Similarly, neither measure will apply to companies listed on regulated markets which are subject to disclosure requirements consistent with EU legislation (or equivalent international standards).⁸⁹

The potential risks

- 11.131 Finally, long chains of intermediaries introduce new risks into the system. The law ensures that beneficiaries are protected if their trustee acts fraudulently. They are also protected if their trustee becomes insolvent: intermediated securities held on a client’s account would not be available to the intermediary’s creditors.
- 11.132 However, the law would not provide protection if the intermediary was both fraudulent and insolvent. For example, if the intermediary had fraudulently sold a pension fund’s shares to another innocent party, and had then become insolvent, the pension fund would bear the loss. The longer the chains of intermediaries, the greater the risk that one link in the chain might fail.

International consideration

- 11.133 The issue has been examined by UNIDROIT (the International Institute for the Unification of Private Law). From 2006 to 2008, the Law Commission analysed successive drafts of the UNIDROIT Convention to advise the UK Government on the issues involved. The Convention was published in 2009,⁹⁰ and we advised the UK Government to sign and ratify it to bring legal clarity to this important area at an international level.⁹¹ However, little has been done. As of June 2014, the Convention has been signed by only one country (Bangladesh) and has not been ratified.

⁸⁸ Department for Business, Innovation and Skills, *Transparency & Trust: Enhancing the transparency of UK company ownership and increasing trust in UK business – Government response* (April 2014).

⁸⁹ Proposed Fourth Money Laundering Directive COM(2013) 45 final, art 3(5)(a)(i); Department for Business, Innovation and Skills, *Transparency & Trust: Enhancing the transparency of UK company ownership and increasing trust in UK business – Government response* (April 2014) p 9.

⁹⁰ See UNIDROIT Convention on Substantive Rules for Intermediated Securities 2009.

⁹¹ Law Commission, *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Further Updated Advice to HM Treasury* (May 2008).

11.134 The European Commission has also been looking at the issue. It published two consultations on possible new Securities Law Legislation (in 2009 and 2010).⁹² The press release accompanying the second paper explained that it was concerned with “the harmonisation of the legal framework for securities holding and transactions” and that “the Commission will come forward with a legislative proposal before summer 2011”.⁹³ However, no legislative proposals have yet been published.

Consultees’ views

11.135 In the Consultation Paper we asked consultees whether there was a need to review the law of intermediated shareholdings. Consultees’ views were split: few consultees disagreed but several gave “other” responses.⁹⁴

11.136 No consultees appeared to question the trust law analysis of intermediated shareholdings. However, many had concerns about the lack of legal certainty in this area. The Bar Council said it was unhappy that there was any prospect of doubt at all in this area. It recommended that the UNIDROIT Convention should be reconsidered and a principled decision taken on whether to ratify it.

11.137 Several consultees were concerned about the difficulties in exercising the voting rights attached to shares held through an intermediary. The NAPF told us that research has demonstrated that in the UK votes are frequently lost within the investment chain. ShareAction told us that there was a need to ensure that those who held the economic interest in a share had adequate rights to instruct as to the exercise of rights attaching to it. ShareSoc said that:

The growth of nominee accounts in the UK has over the years created a situation where rights are lost and ownership becomes unclear where securities are held in an intermediated relationship It is very disappointing that the UNIDROIT Convention on intermediated securities has not been taken up in the UK or by other states - it at least would provide a clearer entitlement to rights by the beneficiaries.

11.138 HSBC Securities Services thought that there was a need for the law to catch up with the practice of dematerialised and intermediated securities holdings, or at least to codify the current position. It said that:

This could be done very effectively in the UK and would assist in developing the UK’s position of having a clear property law system which is a competitive advantage.

⁹² European Commission, *Legislation on Legal Certainty of Securities Holding and Dispositions: Consultation Document* (2009) and *Legislation on Legal Certainty of Securities Holding and Dispositions: Consultation Document* (2010).

⁹³ European Commission, *Midday Express* (5 November 2010).

⁹⁴ Out of 32 responses, 19 (60%) said yes, 3 (9%) said no and 10 (31%) gave other responses.

11.139 A few consultees disagreed. BNY Mellon, a global custodian, told us that no investor protection issues arose as a result of English law. They thought that, to the extent that there were any issues, these were in respect of overseas securities and cross-border transactions. They observed that:

The need for a harmonised pan-EU framework in respect of clearing and settlement of securities remains: Europe's diverse and fragmented national systems of clearing and settlement have long been recognised as inefficient, prone to error and relatively costly. ... This has not changed.

11.140 BNY Mellon's view was that only efforts at the global (or at least the EU) level would be sufficient to tackle the challenges posed by cross-border chains of custody. This view was shared by other consultees. Allen & Overy LLP doubted whether a review of English law would be helpful in light of the uncertainty surrounding the UNIDROIT Convention. Balfour+Manson LLP thought that any review had to be on an EEA-wide basis, and that:

A UK-only solution is pointless and probably unworkable in a European single market.

A need for review? Our conclusion

11.141 Intermediation offers practical advantages to both issuers and investors. Recording investors' interests in securities electronically in the computerised accounts of an intermediary allows for greater transferability, which in turn enhances liquidity and consequently the value of the securities. It is also administratively convenient: an investor can hold their entire international portfolio through a single intermediary, without having to bear the administrative burden of establishing and maintaining links with issuers and other intermediaries in different settlement systems.

11.142 A dematerialised and intermediated system of securities settlement does, however, introduce risks. If any party in the intermediated tier fraudulently dissipates securities held on its client's account and then becomes insolvent, the end-investor will lose their holdings. It also makes it more difficult for investors to exercise their voting rights, which discourages stewardship activities.

11.143 Given the importance of this area, we think that there is a need for a clear statement of legal principles, which removes any remaining legal anachronisms from this area. In our advice to HM Treasury in 2008, we recommended that the UK should ratify the UNIDROIT Convention, to provide a clear harmonised system reflecting current market practice.⁹⁵ We continue to think that there is a need for the UK to work at a European and international level to bring clarity to the law and to reduce the practical difficulties caused by the intermediated system.

⁹⁵ Law Commission, *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Further Updated Advice to HM Treasury* (May 2008) para 3.36.

11.144 We accept the point made by consultees that a UK-only solution would be unworkable. However, this does not mean that the UK should simply leave the issue to the European Commission. We recommend that the Government should review the current operation of the system, with a view to taking the lead in negotiating solutions at a European or international level.

CONCLUSION

11.145 In this Chapter, we have reached the conclusion that the law of fiduciary duties should not be reformed by statute. Instead, if there is a desire to provide investors with greater rights to sue intermediaries for the loss caused by their unfair behaviour, consideration should be given to a new right.

11.146 We have considered one possible new right, based on section 138D of FSMA. It would be possible to extend the section to allow businesses to sue and to allow actions to be brought for breaches of the FCA Principles for Business, including the requirement that “a firm must pay due regard to the interests of its customers and treat them fairly”.⁹⁶ However, if the Government were sympathetic to this change, we think that the issue would merit further research and debate.

11.147 We then looked at three particular problems which have been raised with us about the investment chain.

11.148 The first concerned the lack of regulation of investment consultants. Many consultees felt that this was anomalous, given the importance of investment consultants in determining the investment strategy of pension funds. We noted that under MiFID, member states are only permitted to add requirements on firms to address specific risks. We concluded that this hurdle has not yet been met: we did not identify a specific risk which would objectively justify extending regulation in this area. However, we ask the Government to continue to monitor this area.

11.149 Secondly, we considered the problems posed by stock lending. We concluded that at this stage the emphasis must be on making the amount of stock lending fees retained by intermediaries more transparent, under the Government's commitment to ensuring the transparency of all pension costs. Trustees and IGCs will also need training and support in their difficult task of monitoring whether the level of stock lending fees which are not rebated offers value for money. We recommend that stock lending fees should be considered alongside the review of the default fund charge cap in April 2017.

11.150 Finally, we considered the problems caused by the law of intermediated securities. We recommend that the Government should review the current operation of the system, with a view to taking the lead in negotiating solutions at a European or international level.

11.151 We make the following recommendations.

11.152 **We recommend that stock lending fees should be considered alongside the review of the default fund charge cap in April 2017.**

⁹⁶ FCA Handbook PRIN 2.1.1R (Principle 6).

11.153 **We recommend that the Government should review the current operation of the system of intermediated shareholding, with a view to taking the lead in negotiating solutions at a European or international level.**

CHAPTER 12

LIST OF RECOMMENDATIONS

CHAPTER 7 – FACTORS IN PENSION TRUST INVESTMENT: A NEED FOR REFORM?

- 12.1 We recommend that TPR considers how the guidance we have set out can be given greater exposure and authority. In the short-term this could be through guidance in its trustee toolkit. In the longer term, we recommend that TPR include our guidance in one of its codes of practice.

[paragraph 7.91]

- 12.2 We recommend that the Financial Conduct Authority consider whether IGCs need further guidance in interpreting the interests of members in default funds.

[paragraph 7.92]

- 12.3 We recommend that the Government should review three aspects of the Occupational Pension Schemes (Investment) Regulations 2005. These are

- (1) the exemption of schemes with fewer than 100 members from the provisions of regulation 4;
- (2) the reference to “social, environmental or ethical considerations” in regulation 2(3)(b)(vii), to ensure that it accurately reflects the distinction between financial factors and non-financial factors; and
- (3) whether trustees should be required to state their policy (if any) on stewardship.

[paragraph 7.94]

- 12.4 We recommend that the Government should review two aspects of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009. These are:

- (1) whether the Regulations should transpose article 18(1) of the IORP Directive; and
- (2) those aspects of regulation 9 which require investment managers to be appointed on a short-term basis and reviewed at least every three months.

[paragraph 7.95]

CHAPTER 9 – DEFINED CONTRIBUTION WORKPLACE PENSIONS: CHALLENGES OF GOVERNANCE

- 12.5 We recommend that independent governance committees embedded within pension providers owe a statutory duty to scheme members to act, with reasonable care and skill, in members’ interests. This duty should not be excludable by contract.

[paragraph 9.87]

- 12.6 We recommend that pension providers should be required to indemnify members of their independent governance committees for any liabilities they incur in the course of their duties.

[paragraph 9.88]

- 12.7 We recommend that, as part of its review of the default fund charge cap in April 2017, the Government should specifically consider whether the design of the cap has incentivised trading over long-term investment and, if so, what measures can be taken to reduce this effect.

[paragraph 9.89]

CHAPTER 11 – DUTIES IN THE INVESTMENT CHAIN: A NEED FOR REFORM?

- 12.8 We recommend that stock lending fees should be considered alongside the review of the default fund charge cap in April 2017.

[paragraph 11.152]

- 12.9 We recommend that the Government should review the current operation of the system of intermediated shareholding, with a view to taking the lead in negotiating solutions at a European or international level.

[paragraph 11.153]

(Signed) DAVID LLOYD JONES, *Chairman*
ELIZABETH COOKE
DAVID HERTZELL
DAVID ORMEROD
NICHOLAS PAINES

ELAINE LORIMER, *Chief Executive*
4 June 2014

APPENDIX A

TERMS OF REFERENCE

A.1 On 26 March 2013 the Law Commission received a reference from the Secretary of State for Business, Innovation and Skills in the following terms:

- (1) To investigate the extent to which, under existing law, fiduciary duties apply to:
 - (a) Intermediaries (including investment managers and pension scheme trustees) investing on behalf of others;
 - (b) those providing advice or other services to those undertaking investment activity.
- (2) To evaluate what fiduciary duties permit or require such persons to consider when developing or discharging an investment strategy in the best interests of the ultimate beneficiaries: in particular, the extent to which fiduciaries may, or must, consider:
 - (a) factors relevant to long-term investment performance which might not have an immediate financial impact, including questions of sustainability or environmental and social impact;
 - (b) interests beyond the maximisation of financial return;
 - (c) generally prevailing ethical standards, and / or the ethical views of their beneficiaries, even where this may not be in the immediate financial interest of those beneficiaries;
- (3) To consult relevant stakeholders in the equity investment chain on their understanding of what the content and application of fiduciary duties in this context is, or should be, and to consider their responses;
- (4) To consider whether fiduciary duties, as established in law or as applied in practice, are conducive to investment strategies that are in the best interests of the ultimate beneficiaries. In particular, to consider whether the duties:
 - (a) reflect an appropriate understanding of the scope of beneficiaries' best interests;
 - (b) are sufficiently certain in content and application to market participants;
 - (c) permit sufficient diversity of strategy;
 - (d) sufficiently encourage long-term investment strategy and consideration of factors which might impact on long-term investment performance;

- (e) allow fiduciaries to invest in line with generally prevailing ethical standards, and / or the ethical views of their beneficiaries, even where this may not be in the immediate financial interest of those beneficiaries;
 - (f) require a sufficient balance of risk and benefit; and
 - (g) are sufficiently balanced against each other.
- (5) To identify any areas where changes to fiduciary duties are needed in relation to these criteria and to make recommendations.

APPENDIX B

LEGISLATIVE PROVISIONS

PENSIONS ACT 1995

Section 33

33.— Investment powers: duty of care.

(1) Liability for breach of an obligation under any rule of law to take care or exercise skill in the performance of any investment functions, where the function is exercisable—

(a) by a trustee of a trust scheme, or

(b) by a person to whom the function has been delegated under section 34,

cannot be excluded or restricted by any instrument or agreement.

(2) In this section, references to excluding or restricting liability include—

(a) making the liability or its enforcement subject to restrictive or onerous conditions,

(b) excluding or restricting any right or remedy in respect of the liability, or subjecting a person to any prejudice in consequence of his pursuing any such right or remedy, or

(c) excluding or restricting rules of evidence or procedure.

(3) This section does not apply—

(a) to a scheme falling within any prescribed class or description, or

(b) to any prescribed description of exclusion or restriction.

Section 34

34.— Power of investment and delegation.

(1) The trustees of a trust scheme have, subject to [section 36(1) and to] any restriction imposed by the scheme, the same power to make an investment of any kind as if they were absolutely entitled to the assets of the scheme.

(2) Any discretion of the trustees of a trust scheme to make any decision about investments—

(a) may be delegated by or on behalf of the trustees to a fund manager to whom subsection (3) applies to be exercised in accordance with section 36, but

(b) may not otherwise be delegated except under section 25 of the Trustee Act 1925 (delegation of trusts [for period not exceeding twelve months]) or subsection (5) below.

(3) This subsection applies to a fund manager who, in relation to the investments, may take the decisions in question without contravening the prohibition imposed by section 19 of the Financial Services and Markets Act 2000 (prohibition on carrying on regulated activities unless authorised or exempt).

(4) The trustees are not responsible for the act or default of any fund manager in the exercise of any discretion delegated to him under subsection (2)(a) if they have taken all such steps as are reasonable to satisfy themselves or the person who made the delegation on their behalf has taken all such steps as are reasonable to satisfy himself—

(a) that the fund manager has the appropriate knowledge and experience for managing the investments of the scheme, and

(b) that he is carrying out his work competently and complying with section 36.

(5) Subject to any restriction imposed by a trust scheme—

(a) the trustees may authorise two or more of their number to exercise on their behalf any discretion to make any decision about investments, and

(b) any such discretion may, where giving effect to the decision would not constitute [the carrying on, in the United Kingdom, of a regulated activity (within the meaning of the Financial Services and Markets Act 2000)], be delegated by or on behalf of the trustees to a fund manager to whom subsection (3) does not apply to be exercised in accordance with section 36;

but in either case the trustees are liable for any acts or defaults in the exercise of the discretion if they would be so liable if they were the acts or defaults of the trustees as a whole.

(6) Section 33 does not prevent the exclusion or restriction of any liability of the trustees of a trust scheme for the acts or defaults of a fund manager in the exercise of a discretion delegated to him under subsection (5)(b) where the trustees have taken all such steps as are reasonable to satisfy themselves, or the person who made the delegation on their behalf has taken all such steps as are reasonable to satisfy himself—

(a) that the fund manager has the appropriate knowledge and experience for managing the investments of the scheme, and

(b) that he is carrying out his work competently and complying with section 36;

and subsection (2) of section 33 applies for the purposes of this subsection as it applies for the purposes of that section.

(7) The provisions of this section override any restriction inconsistent with the provisions imposed by any rule of law or by or under any enactment, other than an enactment contained in, or made under, this Part or the Pension Schemes Act 1993.

Section 35

35 Investment principles

(1) The trustees of a trust scheme must secure—

(a) that a statement of investment principles is prepared and maintained for the scheme, and

(b) that the statement is reviewed at such intervals, and on such occasions, as may be prescribed and, if necessary, revised.

(2) In this section “statement of investment principles”, in relation to a trust scheme, means a written statement of the investment principles governing decisions about investments for the purposes of the scheme.

(3) Before preparing or revising a statement of investment principles, the trustees of a trust scheme must comply with any prescribed requirements.

(4) A statement of investment principles must be in the prescribed form and cover, amongst other things, the prescribed matters.

(5) Neither a trust scheme nor a statement of investment principles may impose restrictions (however expressed) on any power to make investments by reference to the consent of the employer.

(6) If in the case of a trust scheme—

(a) a statement of investment principles has not been prepared, is not being maintained or has not been reviewed or revised, as required by this section, or

(b) the trustees have not complied with the obligation imposed on them by subsection (3),

section 10 applies to any trustee who has failed to take all reasonable steps to secure compliance.

(7) Regulations may provide that this section is not to apply to any scheme which is of a prescribed description.

Section 36

36.— Choosing investments.

(1) The trustees of a trust scheme must exercise their powers of investment in accordance with regulations and in accordance with subsections (3) and (4), and any fund manager to whom any discretion has been delegated under section 34 must exercise the discretion in accordance with regulations.

(1A) Regulations under subsection (1) may, in particular—

(a) specify criteria to be applied in choosing investments, and

(b) require diversification of investments.

(3) Before investing in any manner (other than in a manner mentioned in Part I of Schedule 1 to the Trustee Investments Act 1961) the trustees must obtain and consider proper advice on the question whether the investment is satisfactory having regard to [the requirements of regulations under subsection (1), so far as relating to the suitability of investments, and to] 3 the principles contained in the statement under section 35.

(4) Trustees retaining any investment must—

(a) determine at what intervals the circumstances, and in particular the nature of the investment, make it desirable to obtain such advice as is mentioned in subsection (3), and

(b) obtain and consider such advice accordingly.

(5) The trustees, or the fund manager to whom any discretion has been delegated under section 34, must exercise their powers of investment with a view to giving effect to the principles contained in the statement under section 35, so far as reasonably practicable.

(6) For the purposes of this section “proper advice” means—

(a) if the giving of the advice constitutes the carrying on, in the United Kingdom, of a regulated activity (within the meaning of the Financial Services and Markets Act 2000), advice given by a person who may give it without contravening the prohibition imposed by section 19 of that Act (prohibition on carrying on regulated activities unless authorised or exempt);

(b) in any other case, the advice of a person who is reasonably believed by the trustees to be qualified by his ability in and practical experience of financial matters and to have the appropriate knowledge and experience of the management of the investments of trust schemes.

(7) Trustees shall not be treated as having complied with subsection (3) or (4) unless the advice was given or has subsequently been confirmed in writing.

(8) If the trustees of a trust scheme—

(a) fail to comply with regulations under subsection (1), or

(b) do not obtain and consider advice in accordance with this section,

section 10 applies to any trustee who has failed to take all reasonable steps to secure compliance.

(9) Regulations may exclude the application of any of the preceding provisions of this section to any scheme which is of a prescribed description.

OCCUPATIONAL PENSION SCHEMES (INVESTMENT) REGULATIONS 2005

Regulation 2

2.— Statement of investment principles

(1) The trustees of a trust scheme must secure that the statement of investment principles prepared for the scheme under section 35 of the 1995 Act is reviewed—

(a) at least every three years; and

(b) without delay after any significant change in investment policy.

(2) Before preparing or revising a statement of investment principles, the trustees of a trust scheme must—

(a) obtain and consider the written advice of a person who is reasonably believed by the trustees to be qualified by his ability in and practical experience of financial matters and to have the appropriate knowledge and experience of the management of the investments of such schemes; and

(b) consult the employer.

(3) A statement of investment principles must be in writing and must cover at least the following matters—

(a) the trustees' policy for securing compliance with the requirements of section 36 of the 1995 Act (choosing investments);

(b) 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; and

(c) their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to the investments.

Regulation 4

4.— Investment by trustees

(1) The trustees of a trust scheme must exercise their powers of investment, and any fund manager to whom any discretion has been delegated under section 34 of the 1995 Act (power of investment and delegation) must exercise the discretion, in accordance with the following provisions of this regulation.

(2) The assets must be invested—

(a) in the best interests of members and beneficiaries; and

(b) in the case of a potential conflict of interest, in the sole interest of members and beneficiaries.

(3) The powers of investment, or the discretion, must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole.

(4) Assets held to cover the scheme's technical provisions must also be invested in a manner appropriate to the nature and duration of the expected future retirement benefits payable under the scheme.

(5) The assets of the scheme must consist predominantly of investments admitted to trading on regulated markets.

(6) Investment in assets which are not admitted to trading on such markets must in any event be kept to a prudent level.

(7) The assets of the scheme must be properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings and so as to avoid accumulations of risk in the portfolio as a whole. Investments in assets issued by the same issuer or by issuers belonging to the same group must not expose the scheme to excessive risk concentration.

(8) Investment in derivative instruments may be made only in so far as they—

(a) contribute to a reduction of risks; or

(b) facilitate efficient portfolio management (including the reduction of cost or the generation of additional capital or income with an acceptable level of risk),

and any such investment must be made and managed so as to avoid excessive risk exposure to a single counterparty and to other derivative operations.

(9) For the purposes of paragraph (5)—

(a) an investment in a collective investment scheme shall be treated as an investment on a regulated market to the extent that the investments held by that scheme are themselves so invested; and

(b) a qualifying insurance policy shall be treated as an investment on a regulated market.

(10) To the extent that the assets of a scheme consist of qualifying insurance policies, those policies shall be treated as satisfying the requirement for proper diversification when considering the diversification of assets as a whole in accordance with paragraph (7).

(11) In this regulation—

“beneficiary”, in relation to a scheme, means a person, other than a member of the scheme, who is entitled to the payment of benefits under the scheme:

“derivative instrument” includes any of the instruments listed in paragraphs (4) to (10) of Section C of Annex 1 to Directive 2004/39/EC of the European Parliament and of the Council on markets in financial instruments;

“regulated market” means—

(a) a regulated market within the terms of Council Directive 93/22/EEC on investment services in the securities field;

(b) a regulated market within the terms of Directive 2004/39/EC; or

(c) any other market for financial instruments—

(i) which operates regularly;

(ii) which is recognised by the relevant regulatory authorities;

(iii) in respect of which there are adequate arrangements for unimpeded transmission of income and capital to or to the order of investors; and

(iv) in respect of which adequate custody arrangements can be provided for investments when they are dealt in on that market;

“technical provisions” has the meaning given by section 222(2) of the 2004 Act (the statutory funding objective).

Regulation 6

6.— Disapplication of section 35 of the 1995 Act and of regulations 2 and 3 in respect of certain schemes

1) Section 35 of the 1995 Act and regulations 2 and 3 do not apply to any of the following schemes—

(a) a scheme which has fewer than 100 members; or

(b) a scheme which—

(i) is established by or under an enactment (including a local Act), and

(ii) is guaranteed by a public authority.

(2) In this regulation—

“enactment” includes an enactment comprised in, or in an instrument made under, an Act of the Scottish Parliament;

“local authority” means—

(a) in relation to England, a county council, a district council, a London borough council, the Greater London Authority, the Common Council of the City of London in its capacity as a local authority or the Council of the Isles of Scilly;

(b) in relation to Wales, a county council or county borough council;

(c) in relation to Scotland, a council constituted under section 2 of the Local Government etc. (Scotland) Act 1994: (constitution of councils);

(d) an administering authority as defined in Schedule 1 to the Local Government Pension Scheme Regulations 1997 (interpretation);

“public authority” means—

(a) a Minister of the Crown (within the meaning of the Ministers of the Crown Act 1975);

(b) a government department (including any body or authority exercising statutory functions on behalf of the Crown);

(c) the Scottish Ministers;

(d) the National Assembly for Wales, or

(e) a local authority.

Regulation 7

7.— Disapplication of regulations 4 and 5 in respect of schemes with fewer than 100 members

(1) Regulations 4 and 5 do not apply to a scheme which has fewer than 100 members.

(2) Where regulation 4 does not apply to a scheme by virtue only of paragraph (1), the trustees of the scheme in exercising their powers of investment, and any fund manager to whom any discretion has been delegated under section 34 of the 1995 Act in exercising the discretion, must have regard to the need for diversification of investments, in so far as appropriate to the circumstances of the scheme.

APPENDIX C

LIST OF CONSULTEES

The following consultees submitted non-confidential responses.

Alastair Hudson (University of Southampton)

Allen & Overy LLP

Anna Tilba (Newcastle University Business School)

Association of British Insurers (ABI)

Association of Charitable Foundations

Association of Consulting Actuaries

Association of Corporate Trustees

Association of Member Nominated Trustees

Association of Pension Lawyers

Aviva Investors

Aviva Life & Pensions

Avon Pension Fund

Baker & McKenzie LLP

Balfour+Manson LLP

Ben Rudder

BlackRock Investment Management (UK)

Bank of New York Mellon (BNY Mellon)

BT Pension Scheme

Capita Employee Benefits and Capita Trust Company Limited

Carbon Disclosure Project

CFA Society of the UK

Charles Scanlan

Charlton Frank

Church of England National Investing Bodies

Commercial Bar Association/Bar Council

David Gibbs (University of Hertfordshire)

David Hunter

EIRIS

Eumedion

F&C Investments

Faculty of Advocates, Scotland

Financial Reporting Council

First State Investments

Freshfields Bruckhaus Deringer LLP

Gregg McClymont MP

Hermes Equity Ownership Services

HSBC Securities Services

Iain MacNeil (University of Glasgow)

Institute and Faculty of Actuaries

Institute of Business Ethics

Intergenerational Foundation

International Corporate Governance Network

International Securities Lending Association

Investment Management Association

James Featherby

John Crosthwait

John Needham

Jonathan Mukwiri (Durham University)

Julie Timbrell

Kate Malleson (Queen Mary, University of London)

Legal & General Independent Governance Committee

Legal & General Investment Management

Local Authority Pension Fund Forum

Lorraine Talbot (University of Warwick)

Macfarlanes LLP

Magda Raczynska and Duncan Sheehan (University of Bristol; University of East Anglia)

Margarita Sweeney-Baird (University of Edinburgh Law School)

Marion Hersh

Mercer

MN

National Association of Pension Funds

NEST Corporation

Network for Sustainable Financial Markets

Nick Forbes (Newcastle City Council)

Osborne Clarke

Patrick Ford (University of Dundee)

Paul Kinnersley (Cardiff University)

Pension Protection Fund

Pinsent Masons LLP

Richard Nobbs

Robert A.G. Monks

Royal London Asset Management

RPMI Railpen

Sacker & Partners LLP

Sarasin & Partners LLP

ShareAction¹

ShareSoc (UK Individual Shareholders Society)

Social Finance

¹ ShareAction also sent us a joint letter from themselves and the following: Trucost; Generation Foundation; New Economics Foundation; Climate Markets and Investment Association; Big Society Capital; Association of Chartered Certified Accountants; Brian Hill; Stephen Davis; Paul Watchman; and Baroness Jeannie Drake.

Society of Pension Consultants

Standard Life

Strathclyde Pension Fund

Susan Blackwell

Tax Justice Network

The Law Society of Scotland

Timothy MacDonald

Towers Watson

Trades Union Congress

Turcan Connell

UK Shareholders' Association

UK Sustainable Investment and Finance Association (UKSIF)

UNISON

United Nations Principles for Responsible Investment Initiative (UNPRI)

USS Investment Management

Wealth Management Association

