Fiduciary Duties of Investment Intermediaries

Summary

Consultation Paper No 215 (Summary)
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1. INTRODUCTION

S.1 The Law Commission has been asked to consider how the law of fiduciary duties applies to investment intermediaries. Here we summarise the full Consultation Paper. This is available from our website, together with a pre-prepared response form: see http://lawcommission.justice.gov.uk/consultations/fiduciary_duties.htm

S.2 We seek responses by 22 January 2014. We welcome responses in any form but it would be helpful if responses are submitted using the electronic form on our website.

Comments may be sent:
By email to fiduciary.duties@lawcommission.gsi.gov.uk OR
Before 4 November 2013, by post to:
  Folarin Akinbami, Law Commission, Steel House, 11 Tothill Street, London SW1H 9LJ. Tel: 0203 334 0200
After 4 November 2013, by post to:
  Folarin Akinbami, Law Commission, 1st Floor, Tower, 52 Queen Anne’s Gate, London SW1H 9AG. Tel: 0203 334 0200

THE KAY REVIEW

S.3 This project arose out of the Kay Review, published in July 2012. This was a year-long review of the UK equity market. Professor Kay was highly critical of the way the UK equity market worked.

S.4 Professor Kay’s central criticism was “short-termism”. He felt that investment managers “traded” on the basis of short-term movements, rather than “investing” on the basis of the fundamental value of the company. He also felt that shareholders should do more to control the decisions made by their companies.

S.5 The Review set out ten principles for 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”. Recommendation 9 said that:

   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.

TERMS OF REFERENCE

S.6 This project has been commissioned by the Department for Business, Innovation and Skills (BIS) and the Department for Work and Pensions (DWP). Briefly, we have been asked to do five things:

   (1) To investigate how fiduciary duties currently apply to investment intermediaries and those who provide advice and services to them.

   (2) To 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) To consult relevant stakeholders.

(4) 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. We are asked to carry out this evaluation against a list of factors, balancing different objectives, including encouraging long-term investment strategies and requiring a balance of risk and benefit.

(5) To identify areas where changes are needed.

THE MEANINGS OF “FIDUCIARY DUTY”

S.7 The term “fiduciary duty” is used in many different ways. Pension trustees often use it to emphasise their ethos, which is to act in the interests of their members. For lawyers, it denotes an area of “judge-made” law, often associated with trusts and equities. However, even lawyers use the term in different ways.

S.8 A “fiduciary” is someone who is obliged to act in the interests of others. Sometimes the term “fiduciary duty” has been used in a broad sense to encompass all the various duties a fiduciary owes. The courts have issued stern warnings against using the term in this way. Instead, it is said that the core of fiduciary duty is “the obligation of loyalty”.\(^1\) It sits alongside the other statutory, equitable and common law duties which a fiduciary might owe.

S.9 Our aim is to understand how far the law requires those operating in the investment market to act in the best long-term interests of their clients or beneficiaries. We have therefore adopted a broad interpretation of fiduciary duties. For example, to understand the investment duties of pension trustees we look at pensions legislation, duties which attach to the exercise of a power and duties of care, as well as “fiduciary duties” in the strict sense.

THIS SUMMARY

S.10 Here we provide a brief introduction to the many sources of law relevant to this issue and outline the “investment chain” from saver to shareholder. We use pensions as the example, tracing a chain of intermediaries from the prospective pensioner/saver to the registered shareholder of a UK company.

S.11 We then address four issues which we have been asked to consider:

(1) Pension trustees have duties to invest in the best interests of beneficiaries. We consider how far this requires trustees to maximise financial return over a short time-scale, and how far trustees can consider other factors, such as environmental and social impact.

(2) In contract-based pension schemes, fiduciary duties are much less certain. We ask if the duties on contract-based pension providers to act in the interests of scheme members should be clarified and strengthened.

\(^1\) Bristol and West Building Society v Mothew [1998] Ch 1 at 18.
(3) Whatever the merits of fiduciary duties as established in law, there is evidence of problems in the way they are applied in practice in workplace defined contribution schemes. Legal duties need to be embedded in an industry structure which provides the expertise and resources for good governance; and duties must be enforced by efficient regulation. We note that DWP is carrying out a programme of work in this area and urge consultees to engage with this work.

(4) There is uncertainty over how far fiduciary duties apply to others in the investment chain. We do not propose a general reform of the law of fiduciary duties, but we ask if regulation needs to be strengthened in some specific areas, particularly for investment intermediaries and custodians.
2. MULTIPLE SOURCES OF LAW

S.12 Investment markets are subject to a great deal of law. In the Consultation Paper we outline law from four separate sources: agreements between the parties: the Financial Conduct Authority (FCA); pensions legislation; and “judge-made” law.2

AGREEMENTS BY THE PARTIES

S.13 The starting point for understanding the obligations on financial market participants 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.

FCA HANDBOOK

S.14 For many of the stakeholders we spoke to, the regulatory regime is their overriding concern. The FCA Handbook reflects both domestic and European Union policy decisions. It is now too large to fit in a hand. It is a complex database, which may appear daunting to outsiders, with its many acronyms, classifications and exceptions. It is, however, central to the way UK financial markets work.

PENSIONS LEGISLATION

S.15 The legislation 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”.3 The 1995 Act also obliges trustees to prepare and maintain a “statement of investment principles”.4

S.16 Contract-based pension providers are subject to FCA rules. There are also specific legislative requirements for “stakeholder” pensions, but fewer requirements for non-stakeholder pensions.

“JUDGE-MADE” LAW

S.17 Intermediaries 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, tort and contract. The Consultation Paper outlines three separate types of “judge-made law”: fiduciary duties; duties that attach to the exercise of a power; and duties of care. We outline these briefly below.

2 For further discussion see Consultation Paper, Chapter 4.
4 Pensions Act 1995, s 35.
FIDUCIARY DUTIES

Who is subject to fiduciary duties?

S.18 This is said to be a “notoriously intractable” question.\(^{5}\) In broad terms, fiduciary relationships arise in two circumstances:

(1) **Status-based** – where a relationship falls under a previously recognised category, such as a solicitor and client, trustee and beneficiary, and agent and principal; or

(2) **Fact-based** – where the particular facts and circumstances of a relationship clothe it in a fiduciary character. In 1992, we said that the test is based on “discretion, power to act and vulnerability”,\(^{6}\) but there is no universally accepted definition. The cases suggest that the presence of the following factors may give rise to a fiduciary relationship:

(a) an undertaking to act on behalf of or for another person;

(b) a discretion or power to act which affects the interest of that other person;

(c) the peculiar vulnerability of that other person, shown by:

(i) dependence on information and advice;

(ii) a relationship of confidence; or

(iii) the significance of a particular transaction.

S.19 The issue is rendered more complex by the fact that the courts may find a relationship to be fiduciary for some purposes but not others. In 1992, we described fiduciary obligations as “highly complex, poorly delimited and in a state of flux”.\(^{7}\)

What are the fiduciary duties?

S.20 The irreducible core of fiduciary duty is the duty of loyalty.\(^{8}\) In 1992, we divided the duty of loyalty into four categories:\(^{9}\)

(1) **The “no conflict rule”** – a fiduciary must not place themselves in a position where their own interest conflicts with the principal.

(2) **The “no profit rule”** – a fiduciary must not profit from their position at the expense of the principal.

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\(^{5}\) E Weinrib, “The Fiduciary Obligation” (1975) 25(1) *University of Toronto Law Journal* 1 at 5. For further discussion, see Consultation Paper, Chapter 5.


\(^{7}\) Above, at para 2.4.1.

\(^{8}\) *Bristol and West Building Society v Mothew* [1998] Ch 1.

The “undivided loyalty rule” – a fiduciary owes undivided loyalty to their principal, and therefore must not place themselves in a position where their duty towards one principal conflicts with a duty they owe to another principal.

The “duty of confidentiality” – a fiduciary must not use information obtained in confidence from a principal for their own advantage or for the benefit of another.

Modifying fiduciary duties through consent

S.21 A fiduciary will not be liable for breach of the fiduciary duties not to make a profit and to avoid conflicts if the principal gives consent after a full and proper disclosure has been made to them. This is often termed “fully informed consent”.

DUTIES CONNECTED TO THE EXERCISE OF A POWER

S.22 Broadly speaking, the word “power” means any ability to alter legal relations between parties. However, powers are more commonly discussed in the context of trusts.

S.23 Pension trustees are often given significant powers. In the present context, the most important of these powers is the power of investment, provided by section 34(1) of the Pensions Act 1995 or under a trust deed. This entitles trustees and investment managers to deal with the property of others to create binding contractual relationships. This power is subject to the Pensions Acts, the trust deed and trust law more generally. Judges have also developed specific duties which attach to the exercise of a power.

S.24 In the Consultation Paper, we outline six duties that attach to the exercise of a power.

(1) The power must be exercised for the intended purpose. This is the most important duty, as it concerns the substance of the decision-making.

(2) The power must not be exercised fraudulently. The word “fraud” in this context does not mean deceit, but is used in a broad sense to indicate an act which is not right. It prevents a trustee from exercising a power with the wrong intention.

(3) Trustees must not act under the dictation of another. A power is given to an individual personally, and decisions must be a personal and conscious act of that individual. However, trustees must take advice and the pensions legislation permits some decisions to be delegated to investment managers.

(4) Trustees must not fetter their discretion. They must not agree to exercise their powers in a pre-determined way but must consider the facts and circumstances that are relevant at the time.

10 For further discussion, see Consultation Paper, Chapter 6, paras 6.2 to 6.32.
Trustees should not act capriciously. This rule ensures that a power is not exercised in an irrational way.

Trustees should make decisions after adequate deliberation. However, this is not an onerous duty. The courts have stressed that it is not enough to show that the trustees’ deliberations have fallen short of the highest possible standards, or that the court would have acted in a different way. There must be a serious breach for the courts to intervene.

**DUTIES OF CARE**

Duties of care arise in the law of trusts, contract and tort, and 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 the service with reasonable care and skill. 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.”

There are many elements to trustees’ duties of care. Key among these is the idea of managing risk or “prudence”. The case of *Re Whiteley* states that in exercising a power to invest, a trustee should:

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

The concept of risk must be understood in light of modern portfolio theory, which emphasises the risk level of the entire portfolio rather than the risk attaching to each investment taken in isolation.

**THE INTER-RELATIONSHIP BETWEEN THESE SOURCES OF LAW**

These various legal regimes are often complex in themselves, and 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.

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.

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11 Pitt v Holt [2013] UKSC 26 at [73].
12 For further discussion, see Consultation Paper, Chapter 6, paras 6.33 to 6.67.
13 See, for example, Hedley Byrne v Heller [1964] AC 465.
14 Re Whiteley (1886) 33 Ch D 347 at 355, by Lindley LJ.
3. THE INVESTMENT CHAIN: FROM PENSION SAVER TO SHAREHOLDER

S.30 In our Consultation Paper we focus on UK pension funds. They are a crucial investment for many UK citizens, and an area where people are particularly vulnerable to the failures of financial markets. We use 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 involves, among others, investment consultants, investment managers, collective investment schemes, brokers and custodians.

THE CHANGING PENSIONS LANDSCAPE

S.31 The pensions landscape is changing rapidly. Old defined benefit pension schemes are closing and people are increasingly entering into more individual, contract-based arrangements.

S.32 There are two main types of occupational pension scheme administered by or on behalf of an employer:

1. “Defined benefit” (DB) schemes provide a pre-determined amount on retirement, often calculated on the basis of the employee’s final salary and length of service. The employer makes a contractual promise to pay and bears the risk of the fund under-performing.

2. “Defined contribution” (DC) schemes. Here the contributions are fixed but the amount of the individual’s pension will depend on multiple factors including the performance of investments, the fees charged and the annuity rate obtained.

Trust-based and contract-based

S.33 In the private sector all DB schemes are set up under trust. However, DC schemes may be trust-based or contract-based. Where they are set up under trust, the trustees have a responsibility to review and monitor the investments. Both DB and DC trustees are under duties to act in the best interests of their beneficiaries.

S.34 Where a DC scheme is set up under a contract, pension providers are not subject to the same fiduciary duties. There is less oversight of investment strategy over time and more dependence on specific regulations.

Automatic enrolment

S.35 Automatic enrolment is being phased in from October 2012 to October 2018. It has started with large employers and will gradually be extended to medium and small employers.
S.36 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. Of this, at least 3% must come from the employer.

S.37 Employers may use an existing scheme or set up a new scheme. To give every employer access to a scheme, the Government has set up the National Employment Savings Trust (NEST), a low-cost trust-based DC scheme. However, employers may choose other providers. Automatic enrolment may put new pressures on the system, as some small employers are required to make decisions about pensions for the first time.

A DB PENSION INVESTMENT CHAIN

S.38 In a DB pension scheme, the trustees are central. They have responsibility for the investment strategy, and are advised by actuaries and investment consultants. The trustee then gives a mandate to the investment manager. The investment manager may invest in a variety of assets, including direct equities or collective investment schemes. They do this by using platforms, brokers and custodians. Below we outline the main intermediaries used by trustees.

Actuaries

S.39 The foundation of investment decisions is the actuarial valuation, carried out at least every three years. The actuary determines the liabilities of the scheme and calculates the returns which the scheme needs to make to meet these liabilities.

Investment consultants

S.40 The role of the investment consultant is to provide strategic advice: they do not pick individual investments. Following the actuarial valuation, the investment consultant produces a plan of how to achieve the required returns, 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.

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15 In 2013/14, the band is between £5,668 and £41,450 a year.
16 For further discussion, see Consultation Paper, Chapter 3, paras 3.4 to 3.44.
17 Pensions Act 2004, s 224.
S.41 The investment consulting market is highly concentrated: three large consultancies dominate the market. Furthermore, investment consultants often wield significant influence over the structure of pension scheme investments. As one research study put it:

While consultants perceive their role purely as advisory, the trustees for the most part regard consultant’s advice to be “telling” or directing the trustees what investment strategy to pursue.18

S.42 Investment consultants owe a duty to their clients to use reasonable care and skill in carrying out this work. They may seek to exclude or limit their liability, but section 2(2) of the Unfair Contract Terms Act 1977 requires that any restriction is reasonable. In the Consultation Paper we consider whether investment consultants are subject to fiduciary duties to avoid conflicts of interest. We conclude that the outcome of any litigation is uncertain.

S.43 In our meetings with stakeholders, concern was expressed about the apparent lack of regulation of investment consultants. Where investment consultants offer “generic advice” on strategy rather than advice on specific investments, they are not regulated by the FCA. Below we ask if this issue needs review.

The investment manager

S.44 Investment managers handle the day-to-day management of assets, acting on the basis of instructions given to them in the mandate. 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. In larger funds there may be more than one investment manager, so that no single manager has an understanding of the trust’s entire investment structure.

S.45 Investment managers are regulated by the FCA, as they advise on and make specific investment decisions. They are also subject to specific duties under the pensions legislation, which are similar to those placed on trustees.

S.46 Professor Kay criticised the way investment managers are monitored. He argued that asset holders monitor investment managers too frequently and on the basis of misleading benchmarks.19 Research on this issue found that investment managers were rarely asked to take a holistic view of the value of companies, for example by looking at their environmental impact.20

S.47 In our meetings with stakeholders we were told of an “accountability gap”. Investment managers often assume that trustees should explicitly instruct them to take wider factors into account, if that is what the trustees want. Meanwhile, trustees may feel that it is not their place to dictate to the investment manager.

The investment platform

S.48 Not all investments are structured around an investment platform but many are. Platforms have two main functions. They provide:

(1) *Technology*. The platform is an IT system which allows the investment manager to review holdings and to issue instructions to buy or sell assets.

(2) *Access to markets*. The platform will receive instructions from the investment manager, which it may well aggregate with instructions received from other clients, before going into the market through brokers (possibly in-house) to execute the necessary trades.

Collective investment schemes

S.49 Increasingly, pension funds do not invest directly in shares or bonds but in other funds. There are two main types: open-ended investment companies (OEICs) and unit trusts.

S.50 An OEIC is set up under the Open-Ended Investment Companies Regulations 2001\(^{21}\) and is regulated by the FCA.\(^{22}\) In an OEIC, investors purchase shares, which gives them contractual rights against the company. These rights are typically rights to have the shares repurchased by the company at a price determined by the performance of the underlying assets in the fund run by the company. The beneficiaries do not gain any rights against the assets which the OEIC purchases: these are owned by the OEIC itself.\(^{23}\) It is not clear that an OEIC owes fiduciary duties to the end investor.

S.51 By contrast, in a unit trust investors are beneficiaries under a trust, and they do gain collective proprietary interests as beneficial owners of the trust assets, held legally by the scheme trustees. A court would be more likely to find that the trustees of a unit trust were under fiduciary duties to act in the interests of beneficiaries, for example, when exercising voting rights on shares.

Brokers

S.52 In the Consultation Paper we provide a brief overview of how shares are bought.\(^{24}\) For illustrative purposes, we assume that the pension scheme, through its investment manager, decides to invest £x in BigOil plc, which is listed on the London Stock Exchange.

S.53 This may be done in several different ways. The investment manager may sell the trust shares that it already owns, or it may use a trading platform. Alternatively, if the order is big enough, the trade may be carried out through the London Stock Exchange (using an in-house or external broker). In some cases, brokers act as agents, matching buyers to sellers. In other cases they act as market makers, selling shares which they own.

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\(^{21}\) SI 2001 No 1228.

\(^{22}\) See FCA Handbook COLL.


\(^{24}\) For further discussion see Consultation Paper, Chapter 3, paras 3.45 to 3.64.
“Best execution”

S.54 The law requires that brokers obtain the best result for their clients. This is known as “best execution”. For example, the FCA rules require that “a firm must take all reasonable steps to obtain, when executing orders, the best possible result for its clients”.\(^\text{25}\) In the absence of regulation, the common law may also require “best execution” through common law duties of care, contractual duties and fiduciary duties.

Charges

S.55 Professor Kay expressed concern about the way that investment managers accounted for broking charges. He commented that the existing obligations make “investment strategies appear more costly relative to trading strategies, and this impression is misleading”.\(^\text{26}\) In its response to the Kay Review, the Government welcomed new initiatives on cost transparency from the Investment Management Association (IMA).\(^\text{27}\)

S.56 In practice, broking charges are not included within the annual management charges of pensions. Instead, they are taken directly from the fund and are implicitly reflected in the performance of the investments. Charges can be complex and may include:

- (1) brokers’ commissions;
- (2) bid-offer spreads – that is, the difference between the price paid when an investment is bought and the price received when an investment is sold;
- (3) foreign exchange fees associated with transactions.

S.57 In September 2012 the IMA published voluntary industry guidance on enhanced disclosure of charges and costs incurred by UK-authorised funds.\(^\text{28}\) The FCA has also launched a thematic review into the issue.

The custodian

S.58 In past times, trustees would have “owned” paper share certificates. For most share owners, physical share certificates have now been replaced by electronic book entries. Today securities are predominantly held electronically and indirectly, through chains of intermediaries.

S.59 Where pension trustees invest in shares, the legal title to the shares will usually be held by a custodian. Collective investment vehicles also use custodians to hold the title to their shares. The job of a custodian is simple: to hold the asset safely and to account for its ownership correctly.

\(^\text{25}\) FCA Handbook COBS 11.2.1R..
The main criticism made of custodians is that they supplement the fee they are given for their administrative duties by lending stock to others. Professor Kay recommended that “all income from stock lending should be disclosed and rebated to investors”. He expressed concern that custodians received fees for lending stock when the risk that the borrower would default was borne by the investor. He thought that this was inconsistent with fiduciary principles.

We think that if a custodian were to lend stock without any contractual authority, this would amount to a breach of fiduciary duty. In practice, however, the issue is governed by the contractual terms in the agreement with the custodian. A court would almost certainly uphold practices which were in line with the agreed terms.

If there is to be any change in stock lending practices by custodians holding the assets of pension funds, we think this would need to be introduced through a change in the FCA rules. Below we ask if this issue needs review.

A TRUST-BASED DC PENSION INVESTMENT CHAIN

In many ways, the investment chain for trust-based DC pension schemes is similar to a DB investment chain. However, there are two main differences.

1. DC schemes are free from the strictures of periodic actuarial valuation. Trustees do not need to match assets to liabilities, as the employee takes the risk that investments will not meet expectations.

2. In DC schemes the assets do not have to be pooled for a common purpose. It is possible to notionally allocate assets to individual employees. This allows employees some choice over how their pension is invested. Where a scheme is used for automatic enrolment, however, it must not force the employee to make a choice. In practice, most members join the default scheme.

A CONTRACT-BASED DC PENSION INVESTMENT CHAIN

In a contract-based pension scheme, there are no trustees. Instead, the employer selects one or more insurance companies to offer pensions to its employees. The employer may use an independent financial adviser to set up the scheme.


30 Above, at para 9.25.

31 At paras 12.61 to 12.63 of the Consultation Paper we describe guidelines on this issue from the European Securities and Markets Authority (ESMA). However, these only apply to some collective investment schemes and not to custodians holding assets for pension trustees.

32 For further discussion, see Consultation Paper, Chapter 3, paras 3.72 to 3.80.
The pension provider

S.65 In contract-based schemes, the employee enters into a contract with the pension provider, though the employer chooses the scheme and makes arrangements to collect and pay contributions. 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.33

S.66 In discussions, consultees consistently said that while trustees were subject to fiduciary duties, contract-based providers were not subject to these duties.

S.67 We think this is an over-simplification. Providers must consider the suitability of their products when the member enters the scheme. We think that a pension provider that sells pension plans which are unsuitable for its members would be liable for economic loss caused by a lack of care and skill (in the same way as financial advisers have been held liable).

S.68 However, contractual parties are not subject to the same duties to exercise their powers for the purpose for which they were given. Nor are they subject to the duties placed on trustees by the pensions legislation. Furthermore, any fiduciary duties or duties of care are likely to be interpreted in line with the terms of the contract and regulatory rules. There is also a lack of clarity over how often pension providers must review the suitability of schemes over time. Litigation in this area is inherently uncertain.

Other links in the chain

S.69 For contract-based pensions, the rest of the chain is similar. The insurance company will use an investment manager to select investments according to a mandate, using the services of brokers and custodians.

CONCLUSION

S.70 Pension funds have relatively few in-house staff. Instead they rely on long lines of intermediaries, including consultants, investment managers, platforms and custodians to invest their assets. Furthermore, the chains appear to be growing, with some new participants finding a niche. For example, some investment consultants have started to offer a more “hands-on” service, known as “fiduciary management”, to appoint and monitor investment managers on behalf of trustees. Investment groups may also appoint “proxy agents” to vote at company meetings on their behalf.

S.71 In his review, Professor Kay argued that there were too many intermediaries between the end investor and the investee company. Intermediaries introduce costs into the system, and tend to guide pension schemes towards traditional investment decisions based on quantified data. It is usually these pressures, rather than the law, which discourage schemes from looking at wider investment factors such as environmental and governance issues.

4. PENSION TRUSTEES’ DUTIES TO INVEST IN THE “BEST INTERESTS” OF OTHERS

S.72 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.34

S.73 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.

THE CASES

S.74 The concern that the law requires a narrow focus on financial returns arise from the case of Cowan v Scargill.35

S.75 In Cowan v Scargill, the court said that the duty of the union-appointed trustees was to put the interests of their beneficiaries first, and normally this meant their best financial interests. The court recognised that there may be circumstances in which financially disadvantageous arrangements may be in the beneficiaries’ best interests, but the burden of proving this would rest heavily on the trustees. Fiduciaries could take social and political factors into account when making investment decisions, but would be open to criticism if that meant the investment was less beneficial. Further, fiduciaries 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.

35 [1985] Ch 270.
Cowan v Scargill\textsuperscript{36}

Five union-appointed trustees of a mineworkers’ pension scheme refused to approve an investment plan, unless it excluded all overseas investments and investments in industries directly competing with coal. This was held to be in breach of their fiduciary duties because:

(1) the trustees were motivated by their personal views and a desire to pursue union policy;

(2) many of the beneficiaries (such as widows) would not be directly affected by the health of the mining industry; and

(3) the social benefits were too speculative and remote.

S.76 It is sometimes said that fiduciary duties are concerned with maintaining the highest standards of probity. Buttle v Saunders is a reminder that the duty is to act in the interests of the beneficiary – not to act honourably in a general sense.

Buttle v Saunders\textsuperscript{37}

Trustees under a will had entered into negotiations for the sale of trust property. Draft contracts had been prepared but not concluded. The trustees then received a higher offer but refused it as they felt honour-bound not to withdraw from their initial negotiations. The beneficiaries of the trust challenged this decision.

The court held that there may be circumstances in which trustees could legitimately refuse a higher offer, such as the certainty of the original offer. However, the trustees had only considered the honour of withdrawing from existing negotiations. This was incorrect.

S.77 These cases have sparked great debate. The statement that “the best interests of the beneficiaries are normally their best financial interests” could be seen as precluding pension schemes from taking into account environmental, social and governance (ESG) issues when making investment decisions.

S.78 However, Cowan v Scargill must be read subject to two further cases, which interpret the duty in a more nuanced way. The cases of Martin v City of Edinburgh District Council and Harries v Church Commissioners, outlined below, show that trustees may take ESG factors into account, provided that they do so for the right reason, and in the right way.

\textsuperscript{36} [1985] Ch 270
\textsuperscript{37} [1950] 2 All ER 193.
**Martin v City of Edinburgh District Council**[^38]

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 of being “an apartheid-free authority” in all its dealings. The case was decided under Scots law.

The court held that the Council had failed in their duty as trustees. 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: they did not consider whether it was in the best interests of the beneficiaries or seek professional advice on the issue.

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**Harries v Church Commissioners**[^39]

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 that the Church 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.

The court held that although the Church Commissioners are a charity, the main purpose of their investment powers was to make money. Charitable trustees could restrict investments which conflicted with the work of a charity and exclude investments which would alienate their supporters. However, trustees should not lose sight of the purpose of their investment powers. They should not make financially detrimental investment decisions based on moral concerns where there were differing views among their supporters.

A BUNDLE OF DUTIES

S.79 The legal duties on pension trustees when considering an investment strategy arise from several sources, including the trust deed, pensions legislation, duties attached to the exercise of a power and duties of care. In the Consultation Paper we summarise 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”.40 They also require the portfolio to be properly diversified to “avoid excessive reliance on any particular asset, issuer or group of undertakings”.41

(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.

THE USE OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE FACTORS

S.80 Conventional investment decision-making has always been guided by subjective opinion. For example, in deciding whether to invest in the shares of an electronics firm, a traditional investment manager may look at likely future innovations, the firm’s plans to expand into new markets and the competition it faces from its rivals. Many firms now look at a broader range of issues, often referred to as “environmental, social and governance” (ESG) factors.

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. For example, the Deepwater Horizon saga significantly reduced the value of BP shares. 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 refers to many studies which have found a link between ESG factors and company performance.

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”. Given the evidence that ESG factors can lead to better returns in the long run, the answer is clearly that pension trustees may use wider factors. We hope that we can finally remove this misconception.

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. The law, however, allows trustees discretion not to take an ESG approach if after due consideration they consider that another strategy would better serve the interests of their beneficiaries.

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.

Stewardship may be an element of a trustee’s duty of care. The courts have held that where the trust owns a controlling interest in a small private company, professional trustees should take an interest in what the company is doing. However, this would not apply to a small holding in a public listed company, where the trustees would have little financial influence and may lack the resources for stewardship activities.

At present, only a tiny minority of pension schemes conduct stewardship activities. Research of a sample of 35 of the largest 100 UK pension schemes found that only 2 exhibited “engaged ownership behaviour” such as company research, voting and face-to-face meetings with senior management.

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44 See the discussion of Bartlett v Barclays Bank [1980] Ch 515 at para 6.60 of the Consultation Paper.
We do not think that pension trustees have an enforceable legal obligation to engage in the stewardship of public listed companies. However, for large funds, stewardship is 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. Such engagement is expensive and beyond the resources of most trustees.

NON-FINANCIAL FACTORS

Trustees should focus on providing pensions to their members, rather than furthering their own political, moral or religious views. Trustees should only be guided by ethical factors in limited circumstances.

Trustees should not invest in activities which are illegal. Nor do we think that trustees should invest in activities which contravene international conventions. Outside these narrow areas, however, ethical issues are highly contested. To take a recently debated example, some people think that payday lending at high interest rates is wrong, while others think that the ability to borrow money quickly for short periods provides a useful service.

The current law permits trustees to disinvest from payday lending if they think that public condemnation of the practice will lead to a risk that the business model is unsustainable. But trustees of general pension funds should only disinvest for purely ethical reasons 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.

There are 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 DC schemes, members may be offered an ethical pension as a choice. This may produce a lower return, provided that each member has given informed consent.

CONCLUSIONS

Stakeholders raised five possible factors which trustees may wish to taken into account when making investment decisions. Our conclusions are set out below.

1. Wider factors relevant to long-term investment performance may be taken into account where they would further the purpose of the power of investment. This includes environmental, social and governance factors relevant to financial returns. Trustees should consider, in general terms, whether they will take account of such factors. However, they are free not to use an approach based on these factors if they consider that another strategy would better serve the interests of their beneficiaries.
(2) Wider systemic considerations (or “macroeconomic factors”) may be taken into account. In other words, it is permissible to accept a lesser return in some areas where this is justified by the benefits to the portfolio as a whole. 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 this would better serve their beneficiaries.

(3) “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) General ethical issues, unrelated to risks, returns or the interests of beneficiaries, may only be taken into account in limited circumstances. They may be used in a DB pension fund set up by a religious group, other charity or political organisation. Where DC schemes allow individual members a choice of investment strategies, ethical issues can be taken into account with the members’ consent. In other cases they should only be used where trustees have good reason to think that scheme members share the moral viewpoint and where they anticipate that the decision will not result in lower returns to the fund.

(5) 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.

Q1: Do consultees agree that this is a correct statement of the current law?

EVALUATING THE LAW

S.93 Our terms of reference ask us to evaluate whether fiduciary duties are conducive to investment strategies that are in the best interests of the ultimate beneficiaries. We are asked to do this against listed criteria, which we discuss below.

Does the law reflect an appropriate understanding of beneficiaries’ best interests?

S.94 We think the law is right to focus on the purpose for which trustees have been given their investment powers. Pension trustees should focus on providing pensions. This is not an easy task. For some DC schemes, with low contributions and low returns, the chances of providing employees with adequate incomes in old age may be low. Without a sustained focus on the objective, the chances of success reduce further.

S.95 Pension trustees may come under outside pressure to use their investment powers to further other objectives. We think it may be helpful for trustees to be able to quote the law of fiduciary duties to resist pressures to act in ways which would reduce the benefits available to members.
Our provisional conclusion is that the law reflects an appropriate understanding of beneficiaries' best interests. We ask if consultees agree.

**Q2: Do consultees agree that the law reflects an appropriate understanding of beneficiaries' best interests?**

Is the law sufficiently certain?

The law is flexible and allows trustees wide discretion to invest as they see fit. We see advantages to this flexibility, as it allows trustees to respond to new challenges over time. Our tentative view is that it is worth preserving this flexibility, even if the result is some uncertainty.

The main substance of how pension trustees should exercise their powers is set out in the Occupational Pension Scheme (Investment) Regulations 2005, which do not apply to schemes with fewer than 100 members. We ask if the Regulations should be extended to all schemes.

We note that in Australia, fiduciary duties are set out in statutory “covenants”. We are interested in whether any specific issues in the UK would benefit from similar types of statutory clarification.

**Q3: Do consultees think that the law is sufficiently certain?**

**Q4: Should the Occupational Pension Scheme (Investment) Regulations 2005 be extended to all trust-based pension schemes?**

**Q5: Are there any specific areas which would benefit from statutory clarification?**

Does the law permit a sufficient diversity of strategy?

Some stakeholders argue that the law on investment duties encourages “herding” behaviour. Where individuals seek to protect themselves against criticism by doing what everyone else is doing, legal duties may become a “lemming standard”.

We do not think that “herding” is caused by the law. It is true that duties of care measure behaviour against that of others performing similar services. However, this should be tempered with a healthy dose of common sense; the standard does not measure behaviour simply against what others are doing but what a reasonable trustee would do.

Our provisional conclusion is that the law gives trustees considerable discretion to make their own decisions. So long as they keep the purpose of the power of investment in mind, consider relevant factors and follow the procedural requirements we have outlined, the courts will not second guess their decisions.

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46 SI 2005 No 3378.

Q6: Do consultees agree that the law permits a sufficient diversity of strategies?

Does the law encourage long-term investment strategies?

S.103 There are many pressures on trustees which discourage long-term investment strategies. For DB schemes, these include periodic actuarial valuations and the need to show any deficit in the employer’s company accounts based on current asset values. Furthermore, both DB and DC pension trusts are often small. They lack internal resources and are highly dependent on their investment consultants and investment managers.

S.104 Our provisional conclusion is that these sorts of pressures are the cause of short-term investment strategies – not the law of fiduciary duties.

Q7: Do consultees agree that the main pressures towards short-termism are not caused by the duty to invest in beneficiaries’ best interests?

Allow investments in line with generally prevailing ethical standards?

S.105 As we have seen, trustees should consider ethical issues in only limited circumstances. We see advantages to legal rules which remind trustees that their duty is to provide pensions and not to improve the world in some general sense, possibly at the expense of their beneficiaries.

Q8: Do consultees agree that the law is right to allow trustees to consider ethical issues only in limited circumstances?

A balance of risk and benefit?

S.106 Trustees are required to balance risk and returns. The Occupational Pension Scheme (Investment) Regulations 2005 state that the assets should 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”.

S.107 Some stakeholders argued that the Regulations require too much diversification. We welcome views on this issue. We also ask if the law provides the right balance of risk and return. We would be interested to know whether pension funds may be incurring hidden risks, for example in the recent move towards investments in swaps and derivatives, as part of liability driven investment strategies.

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Q9: Does the law encourage excessive diversification?
Q10: Does the law encourage trustees to achieve the right balance of risk and return?
Q11: Are there any systemic areas of trustees’ investment strategies which pose undue risks?

Is the law satisfactory?

S.108 Finally we ask whether the law works in the best interests of beneficiaries or whether it requires reform. We welcome views on this overarching question.

Q12: Overall, do consultees think that the legal obligations on trustees are conducive to investment strategies in the best interests of the ultimate beneficiaries?
Q13: If not, what specifically needs to be changed?

Consolidation of pension funds

S.109 Finally, many stakeholders told us that the best means of encouraging long-term investment strategies would be to move towards greater consolidation within trust-based pension funds, both DB and DC funds. Consolidation was supported by, among others, the National Association of Pension Funds, UNISON and the Fabian Society. We also note the major consolidation of the Australian pension market.

S.110 We note that DWP consulted on this issue in July 2013.49 If consultees have further views on this issue, we will pass those views to the relevant government departments.

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5. FIDUCIARY-TYPE DUTIES IN CONTRACT-BASED PENSION SCHEMES

DUTIES TO REVIEW SUITABILITY

S.111 Pension trustees are under clear duties to consider and review their statement of investment principles. By contrast, the duties on contract-based pension providers are much less certain.

S.112 Stakeholder pensions and pensions used for the purposes of automatic enrolment must offer a default investment option. Although trustees should review their statement of investment principles at least every three years, there is no equivalent requirement on contract-based providers to review the investment strategy applying to default funds. In July 2013, DWP consulted on whether default funds should be reviewed at least every three years.50

S.113 When a member makes an initial choice of investment strategy, the regulations appear to place the onus on the individual to review and update that choice, even though most people find decisions about pensions to be “complex, hard, unpleasant and time-consuming”.51 There is no clear responsibility on either the employer or the pension provider to tell the member that they have chosen an overly expensive or under-performing fund, which is no longer operating in their interest. The FCA rules impose some duties on providers to consider the suitability of decisions to trade for the end investor, but it is not clear how often investment strategies must be reassessed or when providers should seek new information about their scheme members.52

S.114 Our provisional view is that the rules requiring contract-based pension providers to reassess the suitability of investment strategies over time should be clarified and strengthened, both for default schemes and for chosen schemes. This is to meet the principle in the Government’s response to the Kay Review that pension providers should act in the best long-term interests of their clients.

Independent Governance Committees

S.115 The Consultation Paper summarises the conclusions of a market study published by the Office of Fair Trading (OFT) in September 2013 which highlights concerns about the governance of contract-based pensions. Following discussions with the OFT and DWP, the Association of British Insurers has agreed to introduce Independent Governance Committees embedded within insurance pension providers.

52 For further discussion, see Consultation Paper, Chapter 8, para 8.55 and following.
There are many difficult questions about how these committees will work, including how they will be appointed, resourced and supported in their work. Unlike trustees, the committees will not have the power to change investment strategies or investment managers. Instead they will make proposals to the pension provider’s board, who may act on the proposal or may explain why they do not propose to act. It remains to be seen how far the threat that committees will make their proposals public will influence pension providers.

Furthermore, it is not clear whether members of the committees will be under explicit legal duties to act in the interests of members – and, if so, whether they can exclude liability for breaches of these duties.

Our tentative view is that members of the committees should be subject to clear legal duties to act in the interests of members. We appreciate, however, that if members carry unlimited personal liability for breaches of those duties it may be difficult to find individuals willing to carry out the task. We think that pension providers should provide a full indemnity to the members of their committees for any liabilities they incur. Pension providers are best placed to control the quality of the committees’ work, as they will appoint and resource the committees. An indemnity would give pension providers a clear interest in ensuring that the committees carry out their tasks correctly.

Q14: Do consultees agree that the duties on contract-based pension providers to act in the interests of scheme members should be clarified and strengthened?

Q15: Should specific duties be placed on pension providers to review the suitability of investment strategies over time? If so, how often should these reviews take place?

Q16: Should members of Independent Governance Committees be subject to explicit legal duties to act in the interests of scheme members?

Q17: Should pension providers be obliged to indemnify members of Independent Governance Committees for liabilities incurred in the course of their duties?
6. WORKPLACE DC PENSION SCHEMES: DO FIDUCIARY DUTIES WORK IN PRACTICE?

S.119 Our terms of reference ask us to look not only at fiduciary duties, as established in law, but also at how they are applied in practice. Whatever the merits of fiduciary duties established in law, there is evidence of problems in the way they are applied in practice in workplace DC schemes.

S.120 We described these problems in Chapter 13 of the Consultation Paper, drawing on the OFT market study, other reviews and our discussions with stakeholders. In both trust-based and contract-based schemes, there may be insufficient review of high charges or unsuitable or out-dated investment strategies.

Governance

S.121 The main concerns were that:

1. Many single employer trust-based schemes are too small: trustees often lacked the necessary expertise and support to exercise their duties.

2. Some “master trust” schemes may suffer from conflicts of interest. Trustees who are appointed and paid by the pension provider may not be able to challenge the provider’s actions. In particular, trustees may lack the power to change investment managers when in-house funds are underperforming.

3. Trust-based schemes are regulated by The Pensions Regulator, while contract-based pensions are mainly regulated by the FCA. This dual regulatory system allows possibilities for “regulator shopping”, enabling providers with less capital to choose a scheme with lower prudential requirements.

S.122 It appears that, on their own, legal duties are insufficient to ensure that pension schemes work in the interests of their members. Legal duties need to be embedded in an industry structure which provides the expertise and resources for good governance; and duties must be enforced by efficient regulation.
Charges: should investment transaction costs be included in the overall charge?

S.123 The Kay Review criticised incentives on investment managers to favour short-term trading over long-term investment. 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.53

S.124 In its directions for Government and regulators, the response said that “regulatory practice should favour investing over trading, not the other way round”.54

S.125 This raises the question of how far charging structures should be aimed at encouraging long-term investment. In particular, should investment transaction costs (such as brokers’ commissions and bid-offer spreads) be included within an overall charge? Alternatively, should they be taken straight from the fund as an additional expense?

S.126 The OFT recommends 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.55 On the other hand, allowing transaction costs to be deducted from funds may lead to the opposite problem: it may create inappropriate incentives to trade.

S.127 The IMA has recently consulted on the introduction of a new Statement of Recommended Practice for the financial statements of UK authorised funds. They recommend more comprehensive disclosure of fund performance and charges, and in particular transaction costs. The question is whether transaction costs should be within the single framework charge or whether they should be levied in addition to that charge, and whether such charges should be subject to scrutiny by trustees and Independent Governance Committees.

S.128 DWP is planning to launch a consultation on charges in pension schemes in the autumn of 2013. The Minister for Pensions confirmed in May that he wished to consult on charges, including on whether a cap should be placed on charges in workplace schemes. We hope that DWP will be asking questions about whether investment transaction costs should be included in the stated charge or deducted separately from the fund.


54 Above, para 2.25.

We would urge consultees to respond to DWP with comments on where the balance of advantage lies. 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).

**Conclusion**

We have been asked whether fiduciary duties as applied in practice are conducive to investment strategies in the best interests of the ultimate beneficiaries. In the case of workplace DC pension schemes we think legal duties are insufficient on their own to ensure good outcomes for members. The duties need to be embedded in an industry structure and regulatory framework which reinforces and encourages independent review of investment strategies.

Issues about industry structure and regulatory enforcement are outside our terms of reference. DWP is carrying out a programme of work in this area. We urge consultees to engage with this work programme and respond to the consultation opportunities which are offered.

If consultees have concerns which are not addressed in the consultation, we are happy to receive comments which we will pass to the relevant government agencies.
7. FIDUCIARY DUTIES IN THE REST OF THE INVESTMENT CHAIN

The debate

S.133 One of the key recommendations underpinning Professor Kay’s ideas for reform was that non-excludable fiduciary standards should apply to all relationships in the investment chain which involve discretion over the investments of others or advice on investment decisions.

S.134 In its response to the Kay Review the Government set out a principle for all participants in the equity investment chain. 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”.

Fiduciary duties on those who are not trustees

S.135 Although there are clear fiduciary duties on trustees, the duties on the other participants in the chain are uncertain. As we discuss in Chapter 11 of the Consultation Paper, the current law is very different from the position set out in the Government’s principle. We reach four conclusions:

1. The law is far from clear: the law of fiduciary duties is extremely flexible but also inherently uncertain.

2. The courts look at the contract first, and interpret the parties’ duties to each other in line with the contract. For example, if a contract between two apparently sophisticated parties states that a sale is made on an “execution only” basis, the courts will not go behind the contract to imply duties that the seller should act in the interests of the buyer.

3. The courts are highly influenced by the regulatory regime. They are reluctant to go beyond the rules set out by Parliament and regulators.

4. The courts are cautious in finding that those in the investment chain owe duties to others outside the immediate contractual or trust-based relationship. The classic case is Caparo Industries plc v Dickman, where the House of Lords held that auditors owe duties only to the shareholders of the company which employs them as a body, and only for certain purposes: they have no duty of care to future investors.

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57 [1990] 2 AC 605.
Should the law of fiduciary duties be reformed generally?

S.136 We have considered whether there should be a general reform of the law of fiduciary duties to introduce more certain duties which cannot be excluded by contract. Our provisional view is that the law of fiduciary duties as such should not be reformed by statute. Fiduciary duties are difficult to define and inherently flexible. We think that 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.

S.137 The uncertainty surrounding the definition of fiduciary duties led the Government to avoid using the word “fiduciary” so as to provide clarity to the debate. The difficulties of using the word fiduciary would multiply if one were to attempt statutory reform. Any attempt to change fiduciary duties through legislation would result in new uncertainties and could have unintended consequences, especially for trusts.

S.138 If there is a need for greater clarity in some areas, we think it would be better to enact specific duties rather than attempt to codify an area of law which has always depended on the facts of the case.

Q18: Do consultees agree that the general law of fiduciary duties should not be reformed by statute?

An alternative right to sue?

S.139 There is an argument that where investors suffer loss as a result of the wrongful actions of others, they should be compensated for their loss. This, it is said, would introduce a new ethos into financial markets and deter poor behaviour.

S.140 We have considered whether there are any ways in which such a reform might be introduced, other than through the reform of fiduciary duties. We think that the simplest way would be to extend rights to sue for breach of statutory duty under section 138D of the Financial Services and Markets Act 2000. This allows private persons to bring actions for compensation against financial service providers who have breached FCA rules. However, at present, rights are limited: only a private person can bring an action, and only for breach of certain rules.

S.141 The right could be extended to enable businesses to sue. It could also be extended to enable actions on the basis of the FCA Principles for Business. For example, Principle 6 states that:

A firm must pay due regard to the interests of its customers and treat them fairly.

S.142 Market participants could be given the right to sue any firm which had caused them loss by breaching this principle.

S.143 On the other hand, there are strong arguments against such a change. In practice, trustees are allowed considerable discretion and are rarely liable unless they have acted unreasonably or dishonestly. It is unclear what would be achieved in practice by applying a similar approach along the investment chain.

S.144 Increased rights to sue would not necessarily prevent misbehaviour. Civil litigation is inherently uncertain, costly and slow. Some cases have taken 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.

S.145 The courts are particularly concerned about extending duties to others outside the immediate contractual or trust-based relationship. The courts have counselled against the creation of “liability in an indeterminate amount for an indeterminate time to an indeterminate class”\(^5\) and expressed concern about “a limitless vista of uninsurable risk”\(^6\).

S.146 Our provisional conclusion is 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 would welcome views on this issue.

Q19: Should rights to sue for breach of statutory duty under section 138D of the Financial Services and Markets Act 2000 be extended?

**Strengthening FCA rules**

S.147 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.\(^6\)

S.148 Nevertheless, our discussions with stakeholders emphasised the centrality of FCA regulation. Financial markets cannot function without good regulation. There were many areas in which stakeholders thought that current regulations were inadequate.

S.149 We ask whether there is a need to review FCA rules in two areas: the regulation of investment consultants; and custodians. It is not our responsibility to recommend changes to FCA rules, but we will pass the responses we receive to BIS and the FCA for their consideration.

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\(^5\) *Caparo Industries v Dickman* [1990] 2 AC 605 at 621.

\(^6\) Above, at 643.

S.150 We have not asked about investment managers’ fees as the FCA is already conducting a thematic review. Nor do we ask about the Stewardship Code, as the Financial Reporting Council is currently reviewing the implementation of the Code.

Investment consultants
S.151 Stakeholders expressed concern about the apparent lack of regulation of investment consultants. Investment consultants appear not to fall within the FCA regulatory regime so long as they only give “generic advice”. Questions were raised about potential conflicts of interest, so that an investment consultant’s advice may not be independent. Instead, there is the possibility that the advice might be coloured by a particularly close relationship with an investment manager or the presence of an in-house offering. We conclude that the law on this issue is unclear.

Q20: Is there a need to review the regulation of investment consultants?

Custodians
S.152 Today securities are often held electronically and indirectly. Shares are held through a chain of intermediaries. Instead of “owning” a share certificate, the investor is registered on the computer system of an intermediary, who in turn is registered on the computer system of a higher level custodian. The job of a custodian is to hold the asset safely and to account for its ownership correctly. The world’s financial markets depend on custodians carrying out this function honestly and efficiently. It is therefore important that law and regulation minimise any risks.

THE LEGAL FRAMEWORK
S.153 The first question concerns the legal framework under which intermediated shares are held. In the past there has been some debate over the legal relationship that governs this ownership structure. It can 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. It now seems settled that the arrangement is trust-based, which protects the investor’s interest if one party in the chain becomes insolvent. However, some areas of uncertainty remain.

62 See paras 8.20 to 8.21 of the Consultation Paper.
In October 2009, UNIDROIT produced a convention on the underlying law of intermediated securities. From 2006 to 2008, the Law Commission analysed successive drafts of the convention. We advised the UK Government to sign and ratify the convention to bring legal clarity at an international level. However, the UNIDROIT Convention has not been ratified by any country. Similarly, whilst the European Commission has also been looking at the issue, no legislative proposals have yet been published. We are interested to know whether the law in this area needs to be reviewed to ensure that it is fit for purpose.

**Q21: Is there a need to review the law of intermediated shareholdings?**

**STOCK LENDING**

The main controversy affecting custodians relates to stock lending. This is where custodians lend the client’s investment to a third party, typically to enable the borrower to sell short. This introduces a risk that the borrower may default, though the custodian may obtain collateral to guard against this. Where there is an appropriate term in the contract, the custodian is entitled to retain the fee rather than rebating it to the client. Professor Kay recommended that “all income from stock lending should be disclosed and rebated to investors.”

**Q22: Should the FCA review the regulation of stock lending by custodians?**

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