Law Commission

Reforming the law

# Fiduciary Duties of Investment Intermediaries

# Executive Summary

**Law Com No 350 (Summary)**

**July 2014**

# FIDUCIARY DUTIES OF INVESTMENT INTERMEDIARIES EXECUTIVE SUMMARY

1.1 The Law Commission was asked to consider how the law of fiduciary duties applies to investment intermediaries. We published a Consultation Paper in October 2013,[1] and received responses from 96 consultees.

1.2 This is a summary of our Report,[2] which is available from our website: see http://lawcommission.justice.gov.uk/areas/fiduciary_duties.htm. We have also produced a separate summary of our conclusions on the extent to which trustees may or must take financial and non-financial factors into account when making investment decisions. That document is appended to this summary, and is also available on our website.

## BACKGROUND

1.3 This project arose out of the Kay Review, published in July 2012.[3] In a year-long review of the UK equity market, Professor Kay criticised "short-termism". He advocated "investing" on the basis of the fundamental value of the company, rather than "trading" on the basis of short-term movements.

1.4 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.

In November 2012, the Government published a response to the Kay Review which accepted the analysis and conclusions of the report.[4]

1.5 This project was then commissioned by the Department for Business, Innovation and Skills (BIS) and the Department for Work and Pensions (DWP). Briefly, we were 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.

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

[2] Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350 (Report).

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

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

(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 PENSIONS LANDSCAPE**

1.6 Our Report focuses on pensions. 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.

1.7 We focus on funded pension schemes. These 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,[5] 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.

1.8 Some schemes in the public sector are set up under statute, rather than under trust or contract. In the Report we call these "statutory schemes". The main statutory scheme is the Local Government Pension Scheme (LGPS).

1.9 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.

1.10 Increasingly, however, 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.

[5] 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.

### Auto-enrolment

1.11 Pensions policy is subject to rapid change – of which the most important is "auto-enrolment". This is being phased in from October 2012 to October 2018, starting with large employers.

1.12 Employers are 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 £10,000 a year). Employees have the right to opt out, but they must make a positive decision to do so.

### Pensions regulation: a dual system

1.13 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 (TPR). Contract-based schemes are subject to contract law, and are regulated largely by the Financial Conduct Authority (FCA).

1.14 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.[6] However, for contract-based schemes, FCA rules (rather than TPR) govern the way providers conduct their business.

## MULTIPLE SOURCES OF LAW

1.15 Financial markets are subject to a great deal of law. The Report identifies four sources of law:

(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) **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.

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

(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".[7] The 1995 Act also obliges trustees to prepare and maintain a "statement of investment principles".[8]

(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, tort and contract.

1.16 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, such as duties attached to the exercise of a power and duties of care.

1.17 We discuss fiduciary duties and other "judge-made" duties in Chapter 3 of the Report. The investment duties of pension trustees are summarised in Chapter 4.

## FINANCIAL AND NON-FINANCIAL FACTORS

1.18 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 the beneficiaries.

### Our preliminary view

1.19 The Consultation Paper set out our preliminary view of these issues and received responses from 96 consultees. Only two consultees completely disagreed with our interpretation of the law. However, the issue generated considerable debate with many comments, often on the tone rather than the substance of what we said.

1.20 There were five particular concerns which 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 DB schemes should weigh the interests of the employer against the interests of beneficiaries, and whether different considerations applied to DC schemes.

(2) Several consultees asked us to make it clear that trustees are not required to maximise returns, at the expense of risk factors.

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

[8] Pensions Act 1995, s 35.

(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.

(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.

**Our current view**

1.21 Chapter 6 represents our final conclusions. Our view is that the key distinction is between those factors which are financially material and those which are not. Our guidance for trustees, which summarises those conclusions, is appended to this summary.

**Should the law be reformed?**

1.22 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.

1.23 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.

***The need for guidance***

1.24 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.

1.25 Our Report does not advocate legislation to codify the law, as we think that this could lead to unhelpful rigidity. 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.

1.26 However, we accept that trustees need more guidance. We hope that our 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.

1.27 However, we also think that it would be helpful if TPR were able to endorse these conclusions.

**We recommend that the Pensions Regulator 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 the Pensions Regulator include our guidance in one of its codes of practice.**

1.28 We have also 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, the Government is keen to ensure that the separate regulatory systems governing trust-based and contract-based schemes provide similar levels of protection. We see no reason in principle why members' interests in contract-based default funds should differ from those in DC trust-based default funds.

**We recommend that the Financial Conduct Authority consider whether independent governance committees need further guidance in interpreting the interests of members in default funds.**

### *Reviewing the Occupational Pension Schemes (Investment) Regulations 2005*

1.29 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".[9]

1.30 Following consultation, we think that there are three aspects of the Investment Regulations which could usefully be reviewed.

#### EXTENDING REGULATION 4 TO ALL SCHEMES

1.31 Regulation 4 sets out some requirements as to how how trustees should exercise their investment powers. For example, it states that investment of the scheme assets must be in the best interests of members and beneficiaries;[10] and the investment power to be exercised in a manner "calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole".[11]

[9] Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378.

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

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

1.32 We think that these principles apply to all trust-based schemes as a matter of trust law. However, schemes with fewer than 100 members are excluded from the requirements of regulation 4.[12]

1.33 We think 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. 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.

**We recommend that the Government review the exemption of schemes with fewer than 100 members from the provisions of regulation 4 of the Occupational Pension Schemes (Investment) Regulations 2005.**

A POLICY ON "SOCIAL, ENVIRONMENTAL OR ETHICAL CONSIDERATIONS"

1.34 The Pensions Act 1995 requires a statement of investment principles (SIP) to be prepared and maintained.[13] It must be reviewed at least every three years and the Investment Regulations prescribe the content of a SIP.[14] 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.

1.35 We recommend that regulation 2(3)(b)(vii) should be amended to distinguish more clearly between financial and non-financial factors, in line with our final conclusions. 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.

**We recommend that the Government review the reference to "social, environmental or ethical considerations" in regulation 2(3)(b)(vii) of the Occupational Pension Schemes (Investment) Regulations 2005, to ensure that it accurately reflects the distinction between financial factors and non-financial factors.**

STEWARDSHIP

1.36 Professor Kay saw stewardship as a central function of equities markets,[15] requiring relationships between investors and investee companies based on understanding and engagement. He advocated fewer and deeper relationships based on trust and respect, which favoured "voice" over "exit".

[12] Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 7.

[13] Pensions Act 1995, s 35(1).

[14] Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, regs 2(1)(a), 2(3).

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

1.37 At present there is no duty on pension trustees or other investors to undertake stewardship activities. The cases suggest that any duty is limited to ensuring that a company's assets are administered cautiously, with a view to safeguarding the trust's investments.[16] Nor is there a direct duty on investment managers, provided that they explain why they are not complying with the Stewardship Code.

1.38 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. In the Consultation Paper we commented that direct engagement with companies was expensive and may be beyond the resources of all but the largest funds. Many consultees criticised this statement on the ground that even small funds could undertake stewardship activities if they delegated the work to their investment managers. We now accept that this means that even small and medium funds may play an indirect role in stewarding companies.

1.39 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. 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.

**We recommend that the Government review whether trustees should be required to state their policy (if any) on stewardship.**

**The Local Government Pension Scheme (LGPS)**

1.40 Many public service pension schemes are set up under statute, rather than under trust. The largest of these is the LGPS, which is the only one of the main public service pension schemes that holds and invests assets.[17] The scheme is subject to the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009, and we think that there are two aspects of these regulations which could usefully be reviewed.

1.41 First, in contrast to the duties on private sector occupational pension schemes, there is no specific requirement in the LGPS regulations to invest scheme assets in the best interests of scheme members. This requirement, which is imposed by article 18(1) of the IORP Directive,[18] has only been transposed into UK law for private sector occupational pension schemes.

[16] *Bartlett v Barclays Bank Trust Co Ltd* [1980] Ch 515. Moreover, such a duty will only arise where a trust's shareholding confers a substantial measure of control over a company.

[17] 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.

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

1.42 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". However, 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.

1.43 Secondly, Professor Kay specifically criticised the way in which investment managers were given short-term appointments and reviewed every quarter. We therefore think it would be helpful to review the requirements under regulation 9 that the administering authority must be able to terminate an investment managers' appointment by not more than one month's notice;[19] and that the manager must report to the administering authority at least once every three months.[20]

**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.**

## DC WORKPLACE PENSIONS: CHALLENGES OF GOVERNANCE

1.44 As auto-enrolment is extended to smaller employers, DC pensions have come under the spotlight. In September 2013 the Office of Fair Trading (OFT) published a detailed market study of DC workplace pensions.[21] It noted:

> All pension providers, advisers, and industry experts that we consulted … told us that good governance is crucial to achieving good member outcomes.[22]

### The problem

1.45 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.[23] 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.

[19] Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 SI 2009 No 3093, reg 9(2).

[20] Above, reg 9(3).

[21] Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014).

[22] Above, para 7.18.

[23] Above, para 1.9.

1.46 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. However, there are problems in practice. The OFT found that despite these clear legal duties, smaller schemes may lack the necessary expertise and support, while some master trusts (multi-employer schemes) may lack independence.

**Independent Governance Committees (IGCs)**

1.47 Following the OFT report, the Association of British Insurers agreed to embed IGCs within all providers of contract-based schemes.[24] 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.[25]

**The Government's response**

1.48 In March 2014, 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.[26]

1.49 We welcome these proposals. 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.

**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.**

**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.**

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

[25] Better workplace pensions: Further measures for savers (2014) Cm 8840 p 17.

[26] These are known as "active member discounts".

**Transaction costs: inappropriate incentives to trade rather than invest?**

1.50 The charge cap will not apply to transaction costs, such as brokerage fees and bid-offer spreads. 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.

1.51 The OFT thought that including transaction costs in a single "framework" charge might discourage trading when it is in members' interests.[27] However, allowing transaction costs to be deducted from funds risks the opposite problem: it could create inappropriate incentives to trade.

1.52 The Kay Review stressed that charging structures should encourage long-term investment over short-term trading. In its directions for Government and regulators, the Review said that "regulatory practice should favour investing over trading, not the other way round".[28] It would be extremely unfortunate if the charges cap were to undermine this principle.

1.53 We welcome the promise of FCA rules to make the plethora of other costs more transparent,[29] 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.

1.54 The Government acknowledges that its current proposals are only the start of a process. In particular, it has promised to review its proposed 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. We think this issue should be specifically considered as part of the Government's review.

**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.**

[27] Office of Fair Trading, *Defined contribution workplace pension market study* (2013) para 9.19.

[28] 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.

[29] 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.

## DUTIES IN THE INVESTMENT CHAIN

1.55 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.[30] 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.

### Who might be considered a fiduciary?

1.56 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. Readers are directed to the Report for a full discussion of the current law.[31]

### The Kay Review's recommendations

1.57 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".[32] Furthermore, he thought that these obligations should be independent of the classification of the client, and should not be capable of being contractually overridden.[33] He said that intermediaries' legal responsibilities should be directed to the interests of end-investors.[34]

[30] Consultation Paper, Chapter 3.

[31] Report, Chapter 3.

[32] J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012) p 65.

[33] Above, Recommendation 7.

[34] Above, para 9.9.

1.58 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.[35] 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.[36]

**What is the content of the fiduciary duties?**

1.59 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.

1.60 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. In summary, the principles are as follows:

(1) **The courts are reluctant to assign fiduciary obligations to a commercial relationship.** 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.

(2) **Fiduciary duties are subject to modification by contract.** The courts have held that fiduciary duties are "moulded according to the nature of the relationship and the facts of the case".[37] In this sense, they are only default rules out of which the parties may contract freely.

(3) **The courts may take into account financial regulation.** Regulatory rules may be incorporated into the contract between the parties, or they may inform duties owed by the parties under the general law.

**To whom are the duties owed?**

1.61 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.

[35] 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.

[36] Above, para 3.35.

[37] *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41 at 102, by Mason J.

1.62 The cases in relation to duties of care suggest that the courts are reluctant to find that intermediaries owe duties beyond their immediate clients. We believe they are likely to follow a similar approach in relation to fiduciary duties.

**A need for reform?**

1.63 The current law is very different from the position advocated by Professor Kay. 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.

1.64 We have considered possible reforms to the law in this area. In particular we have considered whether investors should be given greater rights to sue for breaches of FCA rules. Our Report also considers 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?***

1.65 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.

1.66 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. There are also 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.

1.67 Our 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. We have considered one possible such right, based on section 138D of the Financial Services and Markets Act 2000 (FSMA).

### *An alternative right to sue: extending section 138D*

1.68 Section 138D of FSMA allows a "private person" to sue an intermediary who has caused them loss through a breach of the FCA rules. However, the rule is of limited scope, as only some FCA rules are actionable. In particular, a private person cannot bring an action on the basis of the FCA Principles for Business,[38] even though these are often used as the basis of FCA enforcement.

1.69 Whilst there are arguments to be made both for and against an extension of section 138D, it is extremely controversial, with most financial intermediaries opposed to the change. The effect of any such change would be uncertain and potentially disruptive. It might add substantial costs, including insurance and legal costs. We do not feel able to recommend such a change at this stage.

1.70 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".[39] It is possible that a limited extension, subject to suitable defences, could be implemented without undue costs.

1.71 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*

1.72 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.[40]

1.73 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.

1.74 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.

[38] FCA Handbook PRIN 3.4.4R.

[39] 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.

[40] J Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report* (July 2012) Recommendation 7.

1.75 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***

1.76 Concerns were raised about how investment consultants are currently regulated. Investment consultants do not fall within the scope of 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.[41]

This means that regulated investment advice is advice that relates to one or more transactions in specific investments, as opposed to generic advice.[42]

1.77 We have decided not to recommend a review of the regulation of investment consultants. 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.

1.78 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 where certain tests are met and only:

> 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.[43]

[41] Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 SI 2001 No 544, art 53 (emphasis added).

[42] 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, Official Journal L241 of 2.9.2006 p 26, recital 81.

[43] Markets in Financial Instruments Implementing Directive 2006/73/EC, Official Journal L241 of 2.9.2006 p 26, art 4(1).

1.79 Following consultation our conclusion is that this hurdle has not 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***

1.80 The main controversy affecting custodians relates to stock lending (also commonly known as securities lending).[44] This is where the custodian "lends" the investments it holds for its clients to borrowers who wish to "short sell" the shares or other securities.[45] 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.[46] 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.

1.81 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. Stock lending also introduces a conflict of interest into the system, with the long-term interests of, for example, a pension fund diverging from the short-term interests of the speculator who is lent stock. However, despite this potential conflict, stock lending has become a central part of the way that capital markets work.

1.82 We have decided against recommending a review of stock lending at this stage. Instead, we think the emphasis must be on making the amount of stock lending fees retained by intermediaries more transparent, under the Government's commitment to ensure the transparency of all pension costs and charges.

1.83 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.

**We recommend that stock lending fees should be considered alongside the review of the default fund charge cap in April 2017.**

[44] Custodians are the most commonly appointed agents but in some cases investment managers or specialist firms may undertake stock lending.

[45] 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.

[46] The borrower may not necessarily return the "same" securities. Instead, the borrower may return securities of the same type and amount.

***Intermediated securities***

1.84 Our Report considers the system by which investors hold shares and other securities. Few shareholders now hold shares directly from a company: they are now usually held indirectly, often through a chain of intermediaries. Our view is that this relationship operates as a series of trusts.

1.85 We have identified four problems with the law in this area:

(1) **Legal uncertainty.** The law in this area may have been left behind by the speed of recent changes. Many rules of law relevant to the securities market were developed in relation to traditional, paper-based practice, and have not translated satisfactorily to the modern market.

(2) **Difficulties in exercising rights.** Indirect shareholdings mean that investors may find it difficult to exercise their voting and other rights with respect to companies. 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.

(3) **Lack of transparency.** The system of intermediated shareholding leads to a lack of transparency over who ultimately owns shares.

(4) **Potential risks.** Long chains of intermediaries introduce new risks into the system. For example, if intermediaries are fraudulent and insolvent, it is likely that their client will bear the loss. The longer the chains of intermediaries, the greater the risk that one link in the chain might fail.

1.86 Given the importance of this area, we think that there is a need for a clear statement of legal principles. 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.[47] 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. We accept 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 of intermediated shareholding, with a view to taking the lead in negotiating solutions at a European or international level.**

[47] Law Commission, *The UNIDROIT Convention on Substantive Rules regarding Intermediated Securities: Further Updated Advice to HM Treasury* (May 2008) para 3.36.

# APPENDIX

## "IS IT ALWAYS ABOUT THE MONEY?"

## Pension trustees' duties when setting an investment strategy: Guidance from the Law Commission

### BACKGROUND

A.1 In July 2012, Professor Kay published a review of the UK equity market. Among other things he noted 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]

A.2 One of Professor Kay's recommendations was that the Law Commission should review the legal concept of "fiduciary duty" to address uncertainties and misunderstandings on this issue.

A.3 In March 2013, the Government asked the Law Commission to examine the fiduciary duties of investment intermediaries. A central concern was the legal duties of pension trustees when they make investment decisions. In particular, how far may (or must) trustees consider interests beyond the maximisation of financial return, such as questions of environmental and social impact, and the ethical views of their beneficiaries?

A.4 This short document summarises the Law Commission's conclusions on these issues. For a full statement, readers are directed to the Law Commission's final Report, in particular Chapter 6.[2] The Report follows a Consultation Paper, published in October 2013.[3]

### DUTIES OF PENSION TRUSTEES

A.5 The legal duties of pension trustees derive from at least three sources.

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

[2] Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350. This is available at http://lawcommission.justice.gov.uk/areas/fiduciary_duties.htm.The Report was laid before Parliament on 30 June 2014 and published on 1 July 2014.

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

**The trust deed**

A.6 The starting point is the trust deed. Looking at the deed, trustees should ask: what is the purpose of the investment power we have been given, and how can we use that power to promote the purpose of the trust?

**The pensions legislation**

A.7 Next, trustees must act within the confines of the legislation. Regulation 4 of the Occupational Pension Schemes (Investment) Regulations 2005 sets out some general principles. For example an investment power should be exercised in a manner "calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole"; and scheme assets must be properly diversified to "avoid excessive reliance on any particular asset, issuer or group of undertakings."

A.8 Although smaller schemes are excluded from parts of the regulations, we think that these principles apply to all trust-based schemes as a matter of trust law.

**Judge-made duties**

A.9 The legislation operates alongside a variety of "judge-made" duties, including duties that attach to the exercise of a power, duties of care and fiduciary duties.

A.10 Among other things, the courts require that trustees must consider the right issues. In particular, trustees should:

(1) act for the proper purpose;

(2) take into account all relevant considerations, and ignore irrelevant ones;

(3) take advice; and

(4) not "fetter their discretion", by applying a pre-existing judgement;

A.11 In addition, 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.

**THE PRIMARY PURPOSE OF INVESTMENT POWERS**

A.12 In pensions, the purpose of the investment power is usually to provide a pension – with contributions invested to provide a return, often several years into the future. The primary aim of an investment strategy is therefore to secure the best realistic return over the long term, given the need to control for risks.

A.13 The key distinction is between financial and non-financial factors. Financial factors are any factors which are relevant to trustees' primary investment duty of balancing returns against risks. A non-financial factor is one motivated by other concerns, such as improving members' quality of life or showing disapproval of certain industries.

A.14 Trustees may always take account of financial factors. They may also take account of non-financial factors if two tests are met. These are described below.

## FINANCIAL FACTORS

A.15 Trustees are required to balance returns against risk. This is not a question of maximising returns: risks matter just as much as returns. Not all risks can be quantified. They often involve questions of judgement, which must be assessed at the time of the decision, not in hindsight.

### The risks to a company's long-term sustainability

A.16 When investing in equities over the long-term, 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.

A.17 Where poor business ethics raise questions about a company's long-term sustainability, we would classify them as a financial factor which is relevant to risk.

### Trustee *may* take all these factors into account

A.18 Trustees *may* take account of any financial factor which is relevant to the performance of an investment. These include risks to a company's long-term sustainability, such as environmental, social or governance factors (often referred to as "ESG" factors).

A.19 The Law Commission's conclusion is that there is no impediment to trustees taking account of environmental, social or governance factors where they are, or may be, financially material.

### Trustees *should* take financially material factors into account

A.20 The law goes further: trustees *should* take account of financially material risks. But the law does not prescribe a particular approach. It is for trustees' discretion, acting on proper advice, to evaluate which risks are material and how to take them into account.

A.21 It is not necessarily helpful to say that trustees "must" take an ESG approach. The ESG label is ill-defined: it covers a wide variety of risks, and many different approaches. The fact that a particular factor is conventionally classified as an "ESG" factor will not be conclusive as to whether it is financially material to the particular investment.

A.22 Instead the duty may be put in the following terms. When investing in equities over the long-term, trustees should consider, in discussion with their advisers and investment managers, how to assess risks. This includes risks to a company's long-term sustainability.

## NON-FINANCIAL FACTORS

A.23 "Non-financial factors" are factors which might influence investment decisions that are motivated by other (non-financial) concerns, such as improving members' quality of life or showing disapproval of certain industries.

A.24 The distinction between financial and non-financial factors may be illustrated with an example. Withdrawing from tobacco because the risk of litigation makes it a bad long-term investment is based on a financial factor. Withdrawing from tobacco because it is wrong to be associated with a product which kills people is based on a non-financial factor.

A.25 In general, non-financial factors may 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.

A.26 This means that if trustees wish to consider non-financial factors, they should ask two questions.

**Question 1: Do we have good reason to think that scheme members share the concern?**

A.27 Trustees may not impose their own ethical views on their beneficiaries. If trustees wish to take account of a non-financial factor, they must have good reason to think that scheme members would share their concern.

***Is survey evidence required?***

A.28 Not necessarily. In some cases trustees may be able to make assumptions: an example might be activities which contravene international conventions, such as manufacturing cluster bombs. The fact that these are banned by the Convention on Cluster Munitions, ratified by the UK, may give trustees reason to think that most people would consider them to be wrong. When coupled with letters from members agreeing, and no letters disagreeing, trustees would have good reason to think that they were acting on members' concerns rather than their own.

A.29 In other cases, it may be necessary to consult members more formally.

***Must all members agree?***

A.30 We do not think that there needs to be 100% agreement. That will usually be unachievable. If a majority are opposed to an investment while the rest remain neutral, that may be enough.

A.31 The more difficult question is where a majority think that the disinvestment should take place but a minority disagree strongly. In cases where the issue is clearly controversial, the courts would expect trustees to focus on financial factors rather than becoming embroiled in disagreements between the members.

***Do trustees have to consider members' views?***

A.32 No. Trustees *may* consider the views of the beneficiaries when making their investment decisions, but there is no legal requirement for them to do so.[4] However, they should only take account of non-financial factors if they reflect members' views and interests – rather than the views of the trustees.

**Question 2: Does the decision risk significant financial detriment?**

A.33 If trustees wish to take a decision motivated by non-financial factors, they should seek advice from their financial advisers on the effect of the decision on returns to the fund. They should not proceed if the decision risks significant financial detriment to the fund.

A.34 Often excluding a sector of the market will not risk significant detriment. The law does not require a portfolio to be diversified to the fullest extent possible. Instead it is a question of degree. For example, in *Harries*, 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.[5] It was the trustees' discretion and the court would not interfere.

A.35 However, if trustees are advised that a decision would risk significant financial detriment, they should not normally proceed.

**The interaction between the two tests**

A.36 Any decision made on non-financial grounds is subject to both tests. However, the ultimate decision should be looked at in the round, considering the evidence on both questions.

A.37 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.

**Exceptions: when can significant financial detriment be justified?**

A.38 There are two clear exceptions where significant financial detriment is permitted:

(1) where the decision is expressly permitted by the trust deed; and

(2) in DC schemes, where the member has chosen to invest in a specific fund.

A.39 Different considerations may also apply to "affinity groups", as we discuss below.

[4] Unless the trust instrument provides otherwise.

[5] *Harries v Church Commissioners* [1992] 1 WLR 1241 at 1250-1251.

### *A more flexible approach for affinity groups*

A.40 We use the term "affinity groups" to describe schemes where members share a particular moral or political viewpoint. An example would be a pension scheme set up by a religious group, other charity or political organisation.

A.41 Here trustees should still ask the same questions, but the answers may be applied more flexibly. It may be easier to establish a consensus among members. If faced with compelling evidence that all members of the scheme felt strongly about an issue, trustees may be justified in accepting a greater risk of detriment than would otherwise be the case.

A.42 For further information on this issue, please see Chapter 6 of the Report.[6]

## THE STATEMENT OF INVESTMENT PRINCIPLES (SIP)

A.43 Pension trustees are required to 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 when making investment decisions.[7] This does not give trustees any special authority to consider non-financial factors. Any investment strategy in the SIP must accord with the general law.

A.44 The reference to "social, environmental and ethical issues" may be confusing. It would be preferable to think in terms of financial and non-financial factors.

1 July 2014

[6] Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350 paras 6.91 to 6.98.

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