



**Law
Commission**

Reforming the law



Scottish Law Commission

promoting law reform

FIDUCIARY DUTIES OF INVESTMENT INTERMEDIARIES

LSE March 2014

Background to the project

- The project arose out of the Kay Review into short termism in UK equity markets.
 - “Traders” not “owners”.
- Kay recommended the Law Commission review the concept of fiduciary duty as applied to investment, particularly for long-term investments.
- Have used “pension lens” as pension trustees are the archetypical long term investor. Also reflected consultee concerns.
- BIS reference March 2013.
- Consultation period October 22nd 2013 – Jan 22nd 2014.
- Report June 2014.

The background concerns

- Do fiduciary duties preclude consideration of long-term factors or ESG issues by trustees or their investment managers?
- Who in the investment chain is subject to fiduciary duties and what are those fiduciary duties?
- Are the duties of those in the investment chain limited to their contractual obligations or a duty of care or in some other way?
- Are fiduciary duties conducive to investment strategies in the best interests of beneficiaries?

Consultation themes

- We based our consultation on 4 key topics:-
 1. How far the law requires Trustees (and others) to maximise financial returns over a short timescale.
 2. What if any “fiduciary duties” apply along the investment chain.
 3. What are and what should be duties on parties to contract based pensions.
 4. Issues raised by consultees in early meetings.

UK Pensions Market

- Two main types of occupational pension:-
 - i) Defined Benefit. (“Final Salary”). Private sector these are trust based.
 - ii) Defined Contribution (“Money Purchase”). May be trust or contract based.
- Trustees (and providers) will employ actuaries, investment consultants, investment managers, and custodians – “the investment chain”.
- DB schemes and investment in UK equities declined.
- Auto Enrolment Oct 2012 onwards. Trust and contract based.

Are Pension trusts different?

- Traditional trusts 'paternalistic'- the benefactor appointed the trustee to look after his/her estate on behalf of his/her beneficiaries.
- In the pensions context the beneficiaries appoint the trustee to look after their assets on their behalf.
- What, if anything, are consequences of this commercial difference?

What is a “Fiduciary Duty”?

- Term is used in different ways.
- Lawyers – judge made law associated with trust and equity. Quite narrow. Based on case law.
- “Fiduciary” – someone obliged to act in interests of others. All their obligations – much broader. Will be other legal sources than case law.
- Investment markets generally are subject to contracts, FCA regulation, legislation and case law. Complex interrelationship.
- Our consultation based on broad interpretation.

What is a “Fiduciary Duty”?

Narrow Version.

- We have followed our 1992 recommendations. Core attributes are:-
- No conflict
- No secret profit
- Undivided loyalty (core)
- Duty of confidentiality.
- These may be modified by contract (often are).
- = “Legal polyfilla”. Flexibility is a significant advantage.

Wider Version e.g. Trustees Duties

- Trustees duties also derive from trust deed, duties attached to power, duties of care and pension legislation (e.g. Pensions Acts 1995 and 2004) – a broad set of sources (often negative).
- In summary trustees may not:-
 - Fail to consider the ‘best interests’ of beneficiaries.
 - Prioritise other considerations (e.g. moral or ethical considerations) over the ‘best interests’ of beneficiaries without clear mandate to do so.
 - Use the pension funds for a collateral purpose that is not in beneficiaries interests e.g. to support government policy.

Does the law prevent responsible investment?

- *Cowan v Scargill*. Trustees must put interests of beneficiaries first. Usually = best financial interests.
- Trustees main duty is to provide a pension. Core purpose of trust. Is financial.
- But – nothing in the law to prevent Trustees considering ESG factors. Probably good investment practice to consider broad issues.
 - ESG can potentially make companies well-run & more sustainable and this could lead to better long term returns.
 - ESG can be taken into account, provided this is done for the right reason and in the right way.
 - Purely ethical investment decisions more difficult.

Consultee Views

- Most consultees agreed that we have stated the current law correctly and that the law reflects an appropriate understanding of beneficiaries' best interests.
- Consultees also agreed that the law was not the main cause of short termism and that it permitted a sufficient diversity of investment strategies.
- Consultees did not think that the law encouraged excessive diversification.

Consultee Views

- However consultees were evenly divided as to whether **in practice** the law provided sufficient guidance.
- Many thought uncertainty led to an overly narrow interpretation of fiduciary duties.
- Many thought the Occupational Pension Scheme (Investment) Regulations 2005 required revision.
- Whilst some problems market rather than legal most consultees thought better guidance was required although divided as to how.

Consultee Views

- Consultees held strong views on ESG and stewardship.
- Most believed that trustees could – and probably should – take wider issues than short term financial returns into account.
- Evenly divided as to whether ESG should be linked to measurable financial return or pervasive on macro economic basis – problem of definition?
- Consultees accept trustees generally cannot exercise effective direct stewardship but many believed this could be delegated on a pooled basis to investment managers.

Market Issues

- Trust based pension funds vary in size. Majority are small and their trustees have limited time, resources and sometimes expertise.
- Anecdotal evidence limited demand from trustees re ESG.
- Are trustees route to change or intermediaries?
- DB schemes – deficit pressures, accounting rules and triennial valuations.
- “Herding” is market and human instinct – not legal problem.

Investment Chain

- Should fiduciary duties be applied throughout the investment chain?
- Which intermediaries owe duties to beneficiaries or to each other?
- Courts are reluctant to go behind regulation or contracts. Reluctant to extend duties of care.
- Trustees generally only liable if “mad or bad”.
- Fiduciary duties are an uncertain tool to change behaviour but we could consider revision of FCA rules so as to target specific concerns (e.g. charges, stock lending).

Consultee Views

- Most consultees agreed that the law should not be reformed to alter or impose fiduciary duties in the investment chain.
- Most also thought that there should not be a right to sue for breach of statutory duty under s138D of FSMA.
- A strong majority thought there was a need to review the regulation of investment consultants.
- A small majority of consultees thought there should be a review of the law of intermediated shareholdings and that the FCA should review the regulation of stock lending.

Early view

- We are not certain that the law requires legislative reform – clear risks in doing so. Unintended consequences beyond pensions. Loss of flexibility.
- However probably requires clarification.
- How? Is Law Commission report sufficient?
- Any value in adopting Australian statutory covenants? Review of 2005 Regs?
- FCA Regulation targeted against specific problems (charges/stock lending etc)?

Contract based and Auto-Enrolment

- Issues canvassed by OFT.
- No trustees.
 - Who is responsible for beneficiaries' best interests – themselves, employer, provider? How?
 - Consumers have problem distinguishing products, employers ditto + concerns re admin costs, providers prime incentive to produce and sell products.
- Is there a duty to review suitability over time and if so on whom?
- Independent Governance Committees – powers, responsibilities and liabilities? Quasi-trustees or mere advisors? How effective?

Consultee views

- Consultees strongly believed that the duties on contract based pension providers to act in the interests of scheme members should be clarified and strengthened.
- This included point of sale and product suitability over time.
- The responsibilities of IGC members required clarification. Many consultees thought IGC members should have explicit duties to act in pension members best interests with an indemnity from pension providers for liabilities incurred in carrying out those duties.

Legal failure vs Market failure

- Is the problem identified by Prof. Kay a legal or market failure?
- If it is a market failure, is there a market solution?
- Australian example and consolidation of buyers.
- Can make improvements but limits on what can be achieved by law and regulation.