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## **Background Material on the Law of Pension Investment: Extracts from Fiduciary Duties of Investment Intermediaries (Law Commission Report No 350)**

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**Fiduciary Duties of Investment Intermediaries: June 2014  
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**BACKGROUND MATERIAL ON THE LAW OF PENSION INVESTMENT:  
EXTRACTS FROM FIDUCIARY DUTIES OF INVESTMENT INTERMEDIARIES  
(LAW COMMISSION REPORT NO 350)**

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# INTRODUCTION

- 1.1 On 3 November 2016 the Minister for Civil Society, Rob Wilson MP made the following reference to the Law Commission.
- 1.2 The Law Commission is asked:
  - (1) To provide an accessible account of the law governing how far pension fund investment policy may or should consider issues of social impact, looking at
    - (a) Defined contribution default funds;
    - (b) Defined contribution chosen funds; and
    - (c) Defined benefit schemes.
- 1.3 To provide an accessible account of the law governing the forms which may be used by social enterprises.
- 1.4 To consider whether there are legal or regulatory barriers to using pension *funds* for social impact (including investment in social enterprises); and
- 1.5 If appropriate, to set out options for reform.
- 1.6 The Law Commission aims to publish a final report by May 2017.

## THE LAW COMMISSION'S PREVIOUS WORK ON FIDUCIARY DUTIES

- 1.7 This project builds on our 2014 report, *Fiduciary Duties of Investment Intermediaries*.<sup>1</sup> That report set out the pensions landscape and summarised the law governing pension investment, looking first by the duties of pension trustees and secondly at the regulation of contract-based schemes. The report then provided guidance to pension trustees on when they could take environmental and social factors into account.
- 1.8 This project takes our 2014 report one step further. Rather than concentrate on defined benefit funds, it is focused on defined contribution pensions, particularly where funds are chosen by the individual concerned. And rather than look at negative screening we ask when pension funds may be invested positively for social good.

## A CALL FOR EVIDENCE

- 1.9 We are starting this project with a short call for evidence, available at: <http://www.lawcom.gov.uk/project/pension-funds-and-social-investment/>.
- 1.10 We seek answers to our questions by **15 December 2016** to: [commercialandcommon@lawcommission.gsi.gov.uk](mailto:commercialandcommon@lawcommission.gsi.gov.uk).

<sup>1</sup> Available to download from <http://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/>.

## **THE LEGAL BACKGROUND**

- 1.11 We are aware that our call for evidence asks questions but does not describe the current law.
- 1.12 To provide some background to the law in this area, we think it may be helpful to set out extracts from our 2014 report which outline the different types of pension and summarise the law on pensions investment.
- 1.13 In this document we, therefore, reproduce a shortened version of four chapters taken from our 2014 report:
- (1) Chapter 2 provides an introduction to the pensions landscape, outlining the changing nature of pension provision;
  - (2) Chapter 4 sets out the investment duties of pension trustees;
  - (3) Chapter 8 looks at the legal duties on contract-based pension providers;
  - (4) Finally, the accompanying guidance considers how far pension trustees may (or must) consider interests beyond the maximisation of financial return, such as questions of environmental and social impact, and the ethical views of their beneficiaries? It summarises the conclusions the Law Commission reached on these issues.
- 1.14 We are aware that these accounts of the law are now two years old – and that in the fast moving world of pensions policy, two years is a long time. We will be updating our accounts of the law in the course of this project.

## CHAPTER 2: PENSIONS LANDSCAPE

- 2.1 Here we start by describing different types of pension and the way that they are regulated. We then consider recent changes to pension provision.

### TYPES OF PENSION SCHEME

- 2.2 For this project we are only concerned with funded pension schemes. We do not consider unfunded schemes, such as the Civil Service Pension Scheme, or state benefits.
- 2.3 Funded pensions may be arranged either through an employer or by an individual privately. Those arranged by an employer are of two main types:
- (1) “*Defined benefit*” (DB). In the private sector DB schemes are set up under trust,<sup>1</sup> 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.

### DB schemes

- 2.4 DB schemes typically provide employees with a defined proportion of their final or career average salary on retirement.<sup>2</sup> Crucially, the amount an employee is promised does not depend on the performance of investments. Instead, the employer makes a contractual promise to pay a certain amount. Typically, both the employer and employee will make contributions to the scheme which are then invested to generate a return. If the scheme is in deficit,<sup>3</sup> the employer will usually be under an obligation to increase its contributions to the scheme to ensure it is brought back to balance.

<sup>1</sup> 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.

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

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

- 2.5 By comparison with other pension schemes, DB contributions are generous. The Pensions Policy Institute calculates that the total level of contributions required to fund a typical final salary scheme is 21% of salary.<sup>4</sup> By contrast, in 2010 average contributions to DC schemes open to new members were under 9%.<sup>5</sup> DB membership peaked in 1967;<sup>6</sup> many schemes have, therefore, been established for several decades and have built up substantial assets. In 2012 they controlled £1,031 billion of assets, compared with £697 billion of assets in DC schemes.<sup>7</sup>
- 2.6 Private sector DB schemes are set up under trust. As we explain in subsequent chapters, pension fund trustees (like other trustees) owe fiduciary duties to their members. Various duties attach to the exercise of their powers, and the courts have held that they must act in members' best interests.

### ***Statutory DB schemes***

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

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

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

<sup>6</sup> Above, p 13.

<sup>7</sup> Source: National Association of Pension Funds.

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

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

<sup>10</sup> Above, p 15. [Since 2014, there has been substantial consolidation of these funds].

## **DC schemes**

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

### ***Trust-based DC schemes***

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

### ***Contract-based schemes***

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

## **INDIVIDUAL PERSONAL PENSIONS**

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

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

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

<sup>13</sup> See paras 8.28 to 8.36 below.

<sup>14</sup> Pensions Act 2004, s 221(1)(a). For an explanation of "statutory funding objective", see para 2.49 below.

## **GROUP PERSONAL PENSIONS**

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

### ***Options on retirement***

- 2.17 A defined contribution pension is said to “accumulate” during the member’s working life, as contributions are made and invested, and to “decumulate” as the member draws on their savings to provide an income in retirement.
- 2.18 Until recently, individuals were effectively required to use the “pension pot” that they had built up during the accumulation phase to purchase an annuity by the time they turned 75.<sup>18</sup> By taking the pension pot and reinvesting it in corporate bonds and gilts, annuity providers promise to pay an individual a guaranteed income for life. The view of the Government of the day was that annuities were the most efficient way of turning capital into an income stream, and by guaranteeing individuals a constant income regardless of how long they lived reduced their possible future need for income-related support.<sup>19</sup>

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

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

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

<sup>18</sup> The principle of mandatory annuitisation was first introduced by section 32 of the Finance Act 1921. The requirement to annuitise by 75 was introduced by section 30 of the Finance Act 1976.

<sup>19</sup> Department for Work and Pensions, *Modernising Annuities: A Consultative Document* (February 2002) p 5.

- 2.19 In 2011, the Government removed the requirement to annuitise at 75.<sup>20</sup> However, alternative options were limited. Whilst everyone was able to take 25% of their pension pot as a tax-free lump sum, only individuals with pension savings under £18,000 or a guaranteed income in retirement of over £20,000 had full flexibility over the rest of their pension pot.<sup>21</sup> Otherwise, individuals were limited to “capped drawdown”, where they could withdraw a pension of up to 120% of the value of an equivalent annuity per year, or full withdrawal subject to a 55% tax charge.
- 2.20 The 2014 Budget gives individuals a greater amount of choice as to how they access their savings. Under the new system, individuals have the option of purchasing an annuity, or the option of full withdrawal and income drawdown at the marginal tax rate. All individuals retain the option of taking 25% of their pension pot as a tax-free lump sum.
- 2.21 Because there will no longer be a limit on who can take advantage of drawdown products, individuals will be able to choose for themselves whether they prefer the security of an annuity or the flexibility of income drawdown. These changes are intended to come into effect from April 2015.<sup>22</sup>

#### **AUTOMATIC ENROLMENT**

- 2.22 Auto-enrolment is being phased in from October 2012 to October 2018. The scheme has started with large employers and will gradually be extended to medium and small employers.
- 2.23 Employers will be required to enrol all employees between the ages of 22 and state pension age into a pension scheme if they earn over the threshold (currently £9,440 a year). Employees have the right to opt out, but they must make a positive decision to do so. When the scheme is fully introduced, contributions must be at least 8% of band earnings (that is, earnings between £5,668 and £41,450 in 2013/14). Of this, at least 3% must come from the employer.

<sup>20</sup> Finance Act 2011, s 65; sch 16.

<sup>21</sup> Individuals with total pension savings of £18,000 or less could take their entire pension as a lump-sum. 25% of this would be tax-free and the rest taxed at the appropriate marginal tax rate. Individuals with a guaranteed income in retirement of over £20,000 (a pension pot of £310,000 at current annuity rates) could enter “flexible drawdown”. These individuals could withdraw freely from their pension, subject to their marginal rate of income tax.

<sup>22</sup> Transitional provisions have taken effect from 27 March 2014. These include reducing the minimum income requirement for entering flexible drawdown from £20,000 to £12,000, increasing the amount of total pension wealth which can be taken as a lump sum from £18,000 to £30,000, and increasing the capped drawdown withdrawal limit from 120% to 150%. See <http://www.hmrc.gov.uk/pensionschemes/benefits-reg-pens-schemes.htm>.

- 2.24 The duty to auto-enrol applies in respect of employees who are not already active members of a “qualifying scheme”.<sup>23</sup> These are schemes which meet the “qualifying criteria”. UK pension schemes which satisfy these criteria are tax-registered occupational and personal pension schemes that meet certain minimum quality standards, such as a minimum level of employee contributions.<sup>24</sup> Where employees are not already a member of a qualifying scheme, they must be enrolled into an “automatic enrolment scheme”. These schemes must, in addition to satisfying the “qualifying criteria”, satisfy the “automatic enrolment criteria”. They must not contain any provisions which prevent employers from auto-enrolling eligible employees, or which require employees to express a choice or provide information in order to remain an active member of the scheme.<sup>25</sup>
- 2.25 Much of the growth in DC schemes is likely to be in contract-based pensions, but not exclusively. There is also likely to be a growth in “master trusts”, that is trust-based schemes covering multiple employers.<sup>26</sup> The most important “master trust” is the National Employment Savings Trust (NEST), set up by the previous Government to ensure that all employers have access to a low-cost scheme.<sup>27</sup> NEST is run as a trust on a not-for-profit basis and has low contribution and annual management charges.<sup>28</sup>
- 2.26 Other new providers have also been set up as master trusts. In 2013, the Office of Fair Trading (OFT) reported that there were 44 master trusts established in the UK in 2012, and that the market was growing quickly.<sup>29</sup> Some have roots in the occupational pension market. For example, The People’s Pension is set up by a not-for-profit organisation with a background in supplying employee benefits to the construction industry. Others have been established by insurance companies.<sup>30</sup>
- 2.27 As we explore below, auto-enrolment will bring many new employers and employees to DC workplace pensions. It raises new challenges to ensure that such schemes offer good value for money.

<sup>23</sup> Pensions Act 2008, ss 3(2)-(3).

<sup>24</sup> Above, s 16.

<sup>25</sup> Above, s 17.

<sup>26</sup> The Pensions Regulator, *Strategy for regulating defined contribution pension schemes* (October 2013) p 12.

<sup>27</sup> The legislation establishing NEST is contained in the Pensions Act 2008, Pt 1 Ch 5 and orders and regulations issued under this Act.

<sup>28</sup> Currently, the contribution charge is 1.8% and annual management charge is 0.3%. See <http://www.nestpensions.org.uk/schemeweb/NestWeb/public/NESTforSavers/contents/what-does-nest-cost.html>.

<sup>29</sup> Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014) para 4.27.

<sup>30</sup> Above, para 4.9.

## **PENSIONS REGULATION: A DUAL SYSTEM**

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

### **The Pensions Regulator (TPR)**

2.29 TPR is the main regulator for trust-based schemes. It has the following statutory objectives:

- (1) to protect the benefits of members of occupational pension schemes;
- (2) to protect the benefits of members of personal pension schemes (where there is a direct payment arrangement);<sup>31</sup>
- (3) to promote, and to improve understanding of the good administration of work-based pension schemes;
- (4) to reduce the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund; and
- (5) to maximise employer compliance with employer duties and the employment safeguards introduced by the Pensions Act 2008. These duties include the duty to auto-enrol eligible employees.<sup>32</sup>

2.30 From 14 July 2014, the Pensions Act 2014 will add an additional statutory objective to minimise any adverse impact on the sustainable growth of an employer when exercising its functions in relation to scheme funding.<sup>33</sup>

2.31 TPR states that its approach is to educate and enable before resorting to enforcement action.<sup>34</sup> However, it also has extensive powers. These include powers to collect data,<sup>35</sup> to issue improvement notices,<sup>36</sup> and to issue contribution notices to employers who are believed to be avoiding their pension obligations.<sup>37</sup>

<sup>31</sup> For the definition of direct payment arrangement, see para 8.37, footnote 43, below.

<sup>32</sup> Pensions Act 2004, s 5.

<sup>33</sup> Pensions Act 2014, s 48.

<sup>34</sup> The Pensions Regulator, *Corporate plan 2013-2016* (May 2013) p 23.

<sup>35</sup> Pensions Act 2004, ss 63-64.

<sup>36</sup> Above, s 13.

<sup>37</sup> Above, s 38.

- 2.32 TPR is also required to issue codes of practice. These provide practical guidance to trustees on how to comply with the requirements of pensions legislation, including how to make investment decisions. Codes of practice are not statements of the law and there is no penalty for failing to comply with them. However, if relevant they must be taken into account by the regulator, a court or tribunal, including the Pensions Ombudsman.<sup>38</sup>

### **The Financial Conduct Authority (FCA)**

- 2.33 As we discuss in Chapter 8, the FCA regulates contract-based pension providers. It also authorises the investment managers used by trust-based schemes, and firms that provide, promote and advise on personal pensions.
- 2.34 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.<sup>39</sup> However, for contract-based schemes, FCA rules (rather than TPR) govern the way providers conduct their business.

### **The Pension Protection Fund (PPF)**

- 2.35 The PPF was introduced by the Pensions Act 2004.<sup>40</sup> It is designed to protect members of DB schemes if their employer becomes insolvent on or after 6 April 2005, and there are insufficient assets in the scheme.<sup>41</sup> DB pension schemes pay a levy to the PPF which provides some of the funding for such protection. DC schemes are not eligible for protection.<sup>42</sup>
- 2.36 If the member has attained the scheme's normal pension age at the date of insolvency, they will receive 100% of their entitlement. However, other members will only be entitled to 90%, and higher earners will receive less as compensation is subject to a cap.<sup>43</sup> Dependants are limited to 50% of the members' entitlement.<sup>44</sup>

<sup>38</sup> Above, s 90(5); The Pensions Regulator, *Code of Practice No. 7: Trustee Knowledge and Understanding (TKU)* (November 2009) para 5.

<sup>39</sup> See Pension Schemes Act 1993, s 111A and the Personal Pension Schemes (Payments by Employers) Regulations 2000 SI 2000 No 2692.

<sup>40</sup> Pensions Act 2004, Pt 2.

<sup>41</sup> There must be insufficient assets in the scheme to secure benefits on wind up that are at least equal to the compensation that the Pension Protection Fund would pay if it assumed responsibility for the scheme: Pensions Act 2004, s 127(2)(a).

<sup>42</sup> Pensions Act 2004, s 126(1)(a).

<sup>43</sup> For example, from 1 April 2014, at age 65 the effective cap is £32,761.07. [The Pensions Act 2014](#) introduces an increased compensation cap for long service: see s 50; sch 20. For anyone with 21 years or more pensionable service, the cap will be increased by 3% of the standard amount for each full year over 20 years, to a maximum of double the standard amount.

<sup>44</sup> The calculation of this amount will differ depending on whether the member died before or after reaching the normal pension age of the scheme.

### **Ombudsman schemes**

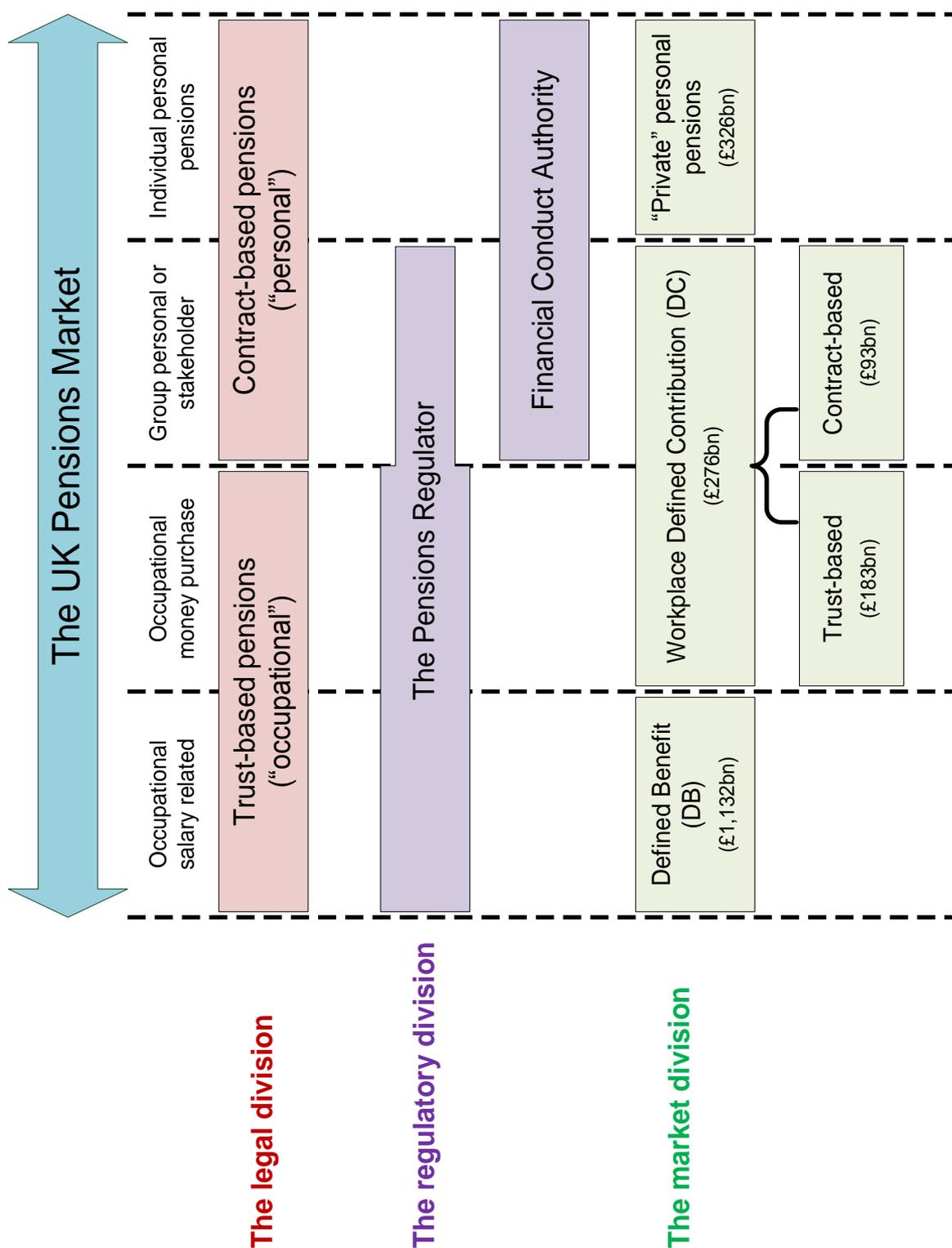
- 2.37 There are two ombudsman schemes which hear complaints about pensions. In practice, the Financial Ombudsman Service deals mainly with complaints about how pensions are sold. The Pensions Ombudsman deals mainly with complaints of maladministration.<sup>45</sup>

### **TYPES OF PENSION SCHEME: A SUMMARY**

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

<sup>45</sup> For more detail of these schemes, see CP 215, Appendix B.

Figure 2.1: Summary of the various forms of pension provision.<sup>46</sup>



<sup>46</sup> Produced by reference to Spence Johnson, *Defined Contribution Market Intelligence* (2013) p 8. We are grateful to Spence Johnson for allowing the data to be reproduced. This diagram is intended only to be a general guide. We are aware, for example, that some personal pensions such as SIPP's may be trust-based. In addition, whilst contract-based pension schemes are subject to regulation by the FCA, all workplace schemes (both contract-based and trust-based) must register with TPR, which oversees payments by employers into the scheme: see para 2.38 above. Therefore, TPR is shown as having a more limited regulatory role for contract-based pensions than for trust-based pensions.

## THE CHANGING NATURE OF OCCUPATIONAL PENSIONS

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

### The decline of DB pensions

- 2.40 DB schemes are a dying breed. Rising life expectancy and low investment returns have significantly increased the cost to employers of offering these schemes. It is estimated that every one-year increase in life expectancy adds about £12 billion to the aggregate pension liabilities of FTSE 100 companies.<sup>47</sup> As schemes have gone into deficit, many employers have been required to make additional contributions.
- 2.41 As a result, many employers have closed DB schemes to new members. The National Association of Pension Funds' 2013 annual survey found that only 12% of private sector DB schemes remained open to new entrants.<sup>48</sup> Some schemes no longer allow further contributions from existing members, and some offer "enhanced transfer values" to encourage deferred members to transfer out of schemes.<sup>49</sup>

### Statutory funding obligations in DB scheme

- 2.42 DB schemes must show they are on track to meet their liabilities.<sup>50</sup> Every scheme is subject to a statutory funding objective which requires it to hold "sufficient and appropriate assets" to make provision for the scheme's liabilities.<sup>51</sup> Actuarial valuations to determine this amount must be prepared at least every three years.<sup>52</sup> In determining whether the scheme has "sufficient and appropriate assets", a current market rate value is given to the assets held.<sup>53</sup>

<sup>47</sup> The Economist, "Running to stand still" (5 August 2006).

<sup>48</sup> NAPF, *Annual Survey 2013* (December 2013) p 6.

<sup>49</sup> Pensions Policy Institute, *The changing landscape of pension schemes in the private sector in the UK* (June 2012) p 35.

<sup>50</sup> The detailed rules governing how employers must fund their DB schemes are in the Pensions Act 2004 and the Occupational Pension Schemes (Scheme Funding) Regulations 2005 SI 2005 No 3377, and are supported by a code of practice: see The Pensions Regulator, *Regulatory Code of Practice 03: Funding defined benefits* (February 2006). In part, these obligations stem from the requirements of the Institutions for Occupational Retirement Provision (IORP) Directive 2003/41/EC, Official Journal L 235 of 23.09.2003 p 10.

<sup>51</sup> Pensions Act 2004, s 222.

<sup>52</sup> Above, s 224.

<sup>53</sup> This is known as a "mark-to-market" valuation.

- 2.43 Failure to meet the statutory funding objective requires the trustees to put a recovery plan in place, setting out the period over which the deficit is to be remedied. A copy must be sent to TPR.<sup>54</sup> TPR expects trustees to look to clear the deficit over a period that is appropriate for the schemes and in line with the affordability of the employer.<sup>55</sup> The trustees are also required to ensure that the assumptions underlying the recovery plan are appropriate for the scheme.
- 2.44 We have been told that this has three effects:
- (1) Trustees' decision-making tends to focus on the actuarial valuations and the employer's obligation to fund the scheme. Actuaries therefore play a crucial role in the investment decisions trustees make.
  - (2) By generating a figure every three years (or less), investment decisions tend to be oriented to much shorter time horizons than the ultimate liabilities the scheme has to meet.
  - (3) When a valuation takes place assets are valued at current market values (known as mark-to-market valuations). This acts as a restraint on long-term thinking.
- 2.45 Any pension deficit must also be shown in the employer's company accounts, based on accounting standards FRS17<sup>56</sup> or IAS19.<sup>57</sup> These accounting standards calculate pension fund liabilities in a different way from that taken by the statutory funding obligations,<sup>58</sup> for example in calculating life expectancies. Like the statutory funding objective, however, the accounting standards use current market values, which again focuses attention on the current rather than future value of pension assets.
- 2.46 The amount of the deficit shown on the accounts may be crucially important to an employer, as it is used as part of the process to determine whether the employer is solvent. A large deficit can significantly depreciate the net value of the employer's assets, and may become an obstacle to what would otherwise have been an advantageous takeover or merger. It is also likely to remain a drag on the employer's trading capacity.<sup>59</sup>

<sup>54</sup> Pensions Act 2004, s 226.

<sup>55</sup> The Pensions Regulator, *Draft code of practice no. 3: Funding defined benefits* (June 2014) paras 140-144.

<sup>56</sup> Financial Reporting Standard 17.

<sup>57</sup> International Accounting Standard 19.

<sup>58</sup> Under the Occupational Pension Scheme (Scheme Funding) Regulations 2005 SI 2005 No 3377, reg 5, trustees are required to choose assumptions "prudently" but the accounting standard looks for a "best estimate". It has been suggested that this may lead to a different deficit figure: see D Pollard and C Magoffin, *Freshfields on Corporate Pensions Law* (1st ed 2013) p 26.

<sup>59</sup> D Fox, *Defined Benefit Pension Trusts: Asset Partitioning and the Residual Interest* (November 2010) pp 5-6.

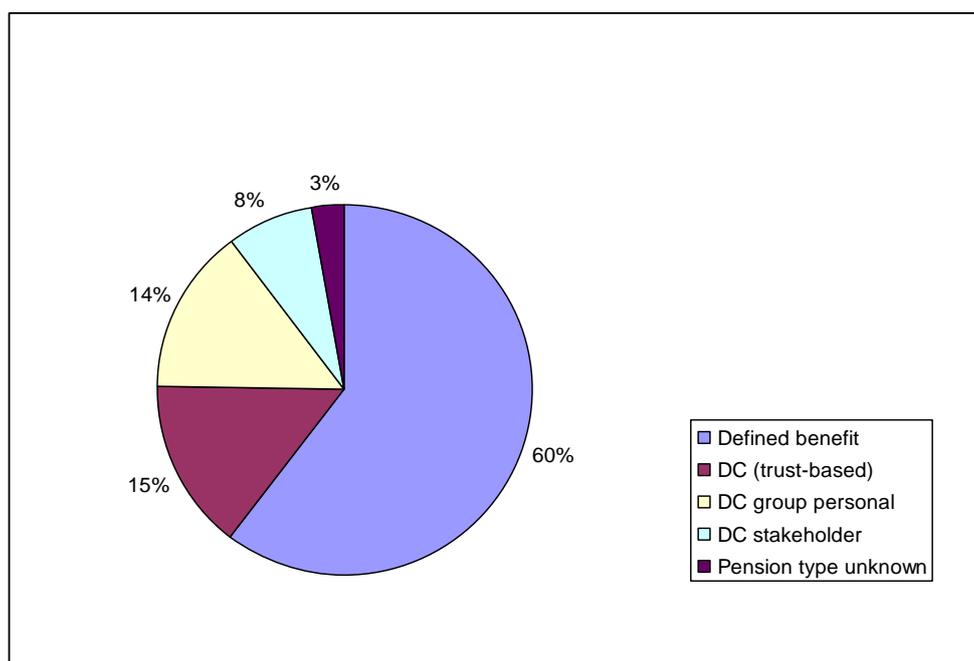
### The growth of DC schemes

- 2.47 DC schemes are “the growth story of pensions”.<sup>60</sup> It is estimated that there are currently 7.9 million memberships in DC schemes.<sup>61</sup>
- 2.48 There are two main drivers of this growth. First, employers who previously offered DB pensions are now offering DC pensions instead. Secondly, automatic enrolment brought many new people into a workplace pension. The Pensions Regulator estimates that, since the introduction of auto-enrolment, more than 3 million employees have been auto-enrolled across more than 10,000 employers.<sup>62</sup> DWP estimates that, when fully phased-in, auto-enrolment will increase the number of individuals newly saving or saving more in a workplace pension by around eight million, and increase the amount that is being saved in workplace pensions by around £11 billion per year.<sup>63</sup>

### The changes in graphs

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

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



<sup>60</sup> M Harrison, “Coming of age?” (July 2013) *Pensions World* 1 at 1.

<sup>61</sup> Spence Johnson, *Defined Contribution Market Intelligence* (2013) p 14.

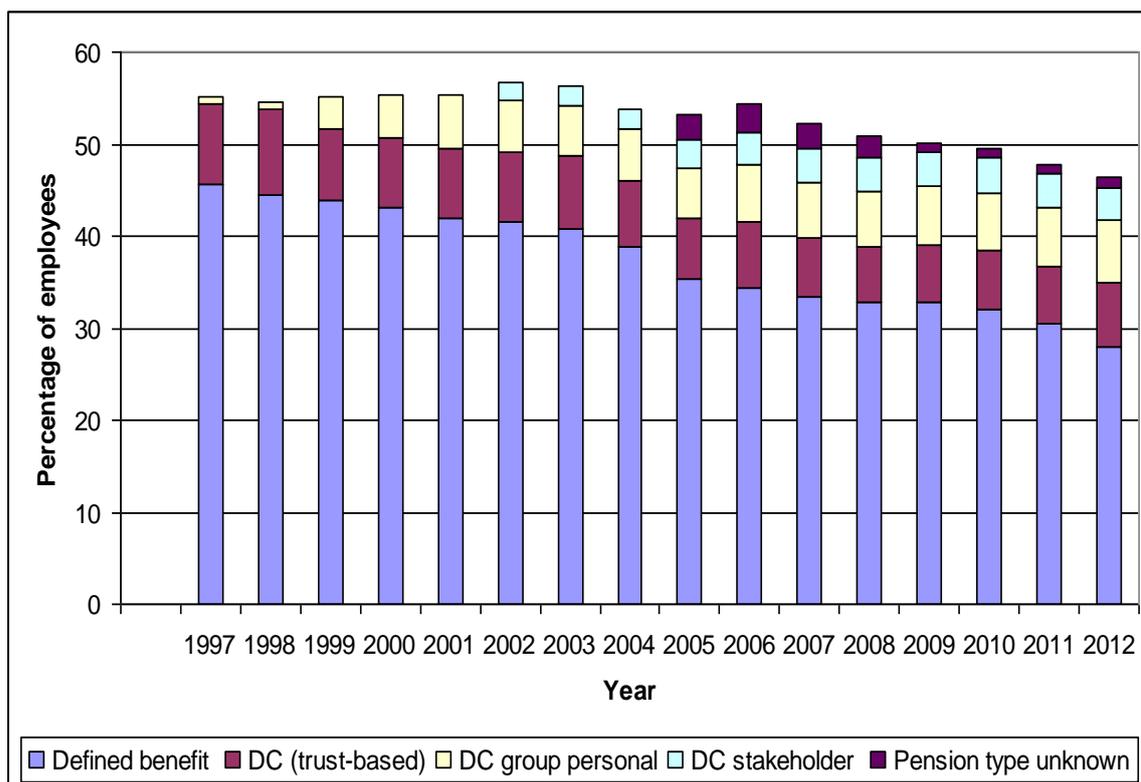
<sup>62</sup> The Pensions Regulator, *Automatic enrolment: Registration report* (May 2014).

<sup>63</sup> Department for Work and Pensions, *Automatic Enrolment evaluation report 2013* (November 2013) p 3.

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

2.50 However, these proportions are changing rapidly. Figure 2.3 shows the steady decline in DB membership and a rise in contract-based stakeholder and personal schemes – a trend which will accelerate with auto-enrolment. It is estimated that DC assets will exceed DB assets by 2022.<sup>64</sup>

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



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

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

<sup>64</sup> Investment & Pensions Europe, *Fiduciary management: A catalyst for growth* (1 October 2012), available at [http://www.ipe.com/magazine/fiduciary-management-a-catalyst-for-growth\\_47675.php](http://www.ipe.com/magazine/fiduciary-management-a-catalyst-for-growth_47675.php).

## **CONCLUSION**

- 2.52 Pension policy faces many challenges. At present most UK workplace pension schemes are trust-based, but this is changing rapidly. Auto-enrolment will lead to growth in contract-based schemes. Concerns have been expressed about how contract-based schemes are regulated. The current system puts the emphasis on individuals to monitor their holdings over time, but people may lack the skills to do this effectively.
- 2.53 Meanwhile, in traditional DB schemes, as many trustees focus on reducing deficits, there is pressure to produce short-term results. We have been told that many of the factors which shape pension trustees' investment decisions do not concern the law. Other pressures are more acute, including those produced by statutory funding objectives and accounting calculations based on mark-to-market valuations. Furthermore, many trust-based pension schemes are small, and in practice many trustees are highly reliant on others in the investment chain.

## CHAPTER 4: INVESTMENT DUTIES OF PENSION TRUSTEES

- 4.1 Pension scheme trustees invest contributions made by members and employers to generate a return. Thus a central role of pension trustees is to oversee investment strategy.
- 4.2 In this Chapter we outline the legal framework that governs the investment decisions of pension trustees. It is in three parts.
- (1) We start with a summary of the pensions legislation which governs trustees' investment powers.
  - (2) We then set out the broad principles of trust law. It is often said that pension trustees should act "in the best interests of their beneficiaries". There are only a handful of cases which interpret what this means and we discuss each in turn. The leading case is *Cowan v Scargill*,<sup>65</sup> though useful guidance is also found in some other cases, notably *Martin v City of Edinburgh District Council*<sup>66</sup> and *Harries v Church Commissioners*.<sup>67</sup>
  - (3) Thirdly, we consider the main funded statutory scheme, the Local Government Pension Scheme (LGPS). This is not technically a trust, though at a practical level the duties of those managing the scheme's assets will be similar.
- 4.3 In the previous Chapter, we explained that to answer practical questions about legal duties in financial markets, it is often necessary to draw on multiple sources of law. This is particularly true when considering the investment duties of pension trustees. To understand their legal duties, pension trustees should start with the trust deed: in particular, does it contain any express limitations on their powers? They should then look to the pensions legislation, outlined below. Finally, they should consider the various "judge-made" duties: particularly the duties connected to the exercise of a power, duties of care and fiduciary duties. We outlined these duties in general terms in the previous Chapter. Here we consider how the courts have applied these duties in a pensions context.

### THE PENSIONS LEGISLATION

- 4.4 The investment decisions of pension trustees are governed by the Pensions Act 1995, the Pensions Act 2004 and the various regulations made under these Acts.

<sup>65</sup> [1985] Ch 270.

<sup>66</sup> [1989] Pens LR 9, 1988 SLT 329.

<sup>67</sup> [1992] 1 WLR 1241.

### **The investment power**

- 4.5 Section 34 of the Pensions Act 1995 provides occupational pension scheme trustees with a wide investment power. They have the same power to make an investment of any kind as if they were absolutely entitled to the assets of the scheme.
- 4.6 However, this power is heavily constrained. It is subject to the provisions of the trust deed, as well as relevant case law. Importantly, this power is also constrained by the Occupational Pension Schemes (Investment) Regulations 2005 (the Investment Regulations).<sup>68</sup> Regulation 4 requires that:
- (1) investment of the scheme assets is in the best interests of members and beneficiaries;<sup>69</sup>
  - (2) the power of investment is exercised in a manner “calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole”;<sup>70</sup>
  - (3) assets held to cover the scheme’s technical provisions are invested in a manner “appropriate to the nature and duration of the expected future retirement benefits payable under the scheme”;<sup>71</sup>
  - (4) scheme assets consist predominantly of investments admitted to trading on regulated markets.<sup>72</sup> Other investments must be kept at a prudent level;<sup>73</sup>
  - (5) scheme assets must be properly diversified to “avoid excessive reliance on any particular asset, issuer or group of undertakings and so as to avoid accumulations of risk in the portfolio as a whole”;<sup>74</sup> and
  - (6) investment in derivative instruments may only be made in so far as they contribute to a reduction of risks or facilitate efficient portfolio management.<sup>75</sup>

<sup>68</sup> SI 2005 No 3378.

<sup>69</sup> Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 4(2).

<sup>70</sup> Above, reg 4(3).

<sup>71</sup> Above, reg 4(4). A scheme’s “technical provisions” means the amount required, on an actuarial calculation, to make provision for the scheme’s liabilities: Pensions Act 2004, s 222(2).

<sup>72</sup> Above, reg 4(5).

<sup>73</sup> Above, reg 4(6).

<sup>74</sup> Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 4(7).

<sup>75</sup> Above, reg 4(8). Derivative instruments are defined as including any of the instruments listed in paragraphs (4) to (10) of Section C of Annex 1 to the Markets in Financial Instruments Directive 2004/39/EC, Official Journal L145 of 30.4.2004 p 1.

- 4.7 Regulation 4 of the Investment Regulations implements article 18(1) of the Institutions for Occupational Retirement Provision (IORP) Directive.<sup>76</sup>
- 4.8 Schemes with fewer than 100 members are excluded from the requirements of regulation 4 of the Investment Regulations,<sup>77</sup> even though small schemes are common.<sup>78</sup> Under the Regulations, trustees of schemes with fewer than 100 members have a more limited duty to have regard to the diversification of investments in so far as appropriate to the circumstances of the scheme.<sup>79</sup> However, we think that many of the elements of regulation 4 already effectively apply to such schemes as a result of general trust law.
- 4.9 If the regulations are breached, the Pensions Regulator (TPR) may take action, including applying civil penalties under the Act.<sup>80</sup>

### **Delegation**

- 4.10 Section 34(2) of the Pensions Act 1995 provides that any decision about investments may be delegated by or on behalf of the trustees to an investment manager authorised (or exempt from authorisation) by the Financial Conduct Authority (FCA). Under section 47(2) of the Pensions Act 1995, where an occupational pension scheme has assets including investments, an investment manager<sup>81</sup> *must* be appointed.
- 4.11 Trustees will often delegate their discretion to make decisions about investments to an investment manager because managing investments belonging to another by way of business, in circumstances involving the exercise of discretion, is a regulated activity requiring FCA authorisation.<sup>82</sup> Whilst some occupational pension scheme trustees are authorised, the vast majority are not.

<sup>76</sup> The Investment Regulations implement the requirements of the Institutions for Occupational Retirement Provision (IORP) Directive 2003/41/EC, Official Journal L 235 of 23.09.2003 p 10.

<sup>77</sup> Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 7.

<sup>78</sup> For example, Spence Johnson reports that, out of 45,295 defined contribution trust-based schemes, 43,804 (97%) had fewer than 100 members: Spence Johnson, *Defined Contribution Market Intelligence* (2013) p 16.

<sup>79</sup> Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 7(2).

<sup>80</sup> See Pensions Act 1995, ss 10 and 36(8)(a).

<sup>81</sup> The Pensions Act 1995 uses the language of “fund manager”, but the terminology of “investment manager” has been adopted in this report.

<sup>82</sup> Financial Services and Markets Act 2000, s 22 and sch 2, para 6; Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 SI 2001 No 544, art 37. However, it is only a regulated activity if, generally, the assets being managed consist of or include any investment which is a security or a contractually based investment.

- 4.12 Occupational pension scheme trustees are taken to be managing scheme assets “by way of business”, even if they are unpaid individuals.<sup>83</sup> The key exception is where trustees delegate decision making to an investment manager. Where the investment manager carries out all the “day-to-day” decisions relating to the management of securities or contractually-based investments and is authorised by the FCA, the trustees will fall within this exception.<sup>84</sup> Therefore, to avoid the need for authorisation, occupational pension scheme trustees must ensure that all such decisions are delegated under the Pensions Act 1995.
- 4.13 There is no definition of what constitutes a “day-to-day” decision. FCA guidance is that such decisions will include:
- (1) decisions to buy, sell or hold particular securities or contractually based investments such as an investment manager would be expected to make in their everyday management of a client's portfolio; and
  - (2) recommendations made to investment managers, on a regular basis, with a force amounting to direction relating to individual securities or contractually based investments.<sup>85</sup>
- 4.14 The effect of these rules is that occupational pension scheme trustees will usually be restricted to making “strategic” decisions only. This will include decisions:
- (1) about the adoption or revision of the statement of investment principles;
  - (2) about the formulation of a general asset allocation policy;
  - (3) affecting the balance between income and growth; or
  - (4) about the appointment of investment managers.<sup>86</sup>

Trustees may also make “day-to-day” decisions about investments in pooled investment products (provided they have taken and considered advice),<sup>87</sup> and in certain exceptional circumstances (for example, takeover situations or where there are sensitive policy considerations).<sup>88</sup>

<sup>83</sup> Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order SI 2001 No 1177, art 4(1).

<sup>84</sup> Above, art 4(1)(b).

<sup>85</sup> FCA Handbook PERG 10.3, Q9.

<sup>86</sup> Above, Q8.

<sup>87</sup> Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order SI 2001 No 1177, arts 4(1)(b), 4(6). Pooled investment products include units in collective investment schemes, shares issued by an investment company and contracts of insurance.

<sup>88</sup> FCA Handbook PERG 10.3, Q8. Occupational pension scheme trustees may also make decisions of any kind about investing in assets that are not securities or contractually based investments, such as real property, cash or precious metals.

### **No exclusion of the duty of care**

- 4.15 As we noted in Chapter 3,<sup>89</sup> pension trustees are under a duty to exercise reasonable care and skill when exercising their powers of investment. Under section 33(1) of the Pensions Act 1995, pension trustees cannot exclude or restrict any liability for breach of an obligation under any rule of law to take care or exercise skill in the performance of investment functions. This marks a stark contrast to other forms of trustee, who may exclude their duties of care.<sup>90</sup>
- 4.16 However, if the trustees delegate their investment discretion to an investment manager in accordance with section 34(2) of the Pensions Act 1995, the trustees will not be responsible for the acts or defaults of the investment manager, provided the trustees have taken all reasonable steps to satisfy themselves that the investment manager is suitable,<sup>91</sup> is carrying out the work competently and is complying with the Investment Regulations.<sup>92</sup>
- 4.17 Meanwhile the investment manager to whom investment discretion is delegated in this way becomes subject to duties under the pensions legislation. In particular:
- (1) Investment managers must exercise their discretion in accordance with the Investment Regulations.<sup>93</sup> This includes the requirement in regulation 4(2) that the investment of scheme assets is in the best interests of the beneficiaries.
  - (2) Investment managers are prohibited from excluding or limiting their liability to take care or exercise skill in the performance of any investment functions.<sup>94</sup> This is in contrast to investment managers in other circumstances, who may limit liability.

<sup>89</sup> See para 3.77 and following above.

<sup>90</sup> In Scotland, liability for gross negligence cannot be excluded: see *Spread Trustee Co v Hutcheson* [2011] UKPC 13 at [48]; *Lutea Trustees Ltd v Orbis Trustees Guernsey Ltd* 1997 SC 255.

<sup>91</sup> Section 34(4) of the Pensions Act 1995 requires trustees to take all reasonable steps to satisfy themselves that an investment manager has the appropriate knowledge and experience for managing the investments of the scheme.

<sup>92</sup> Pensions Act 1995, ss 34(4), 34(6). These sections require trustees to take all reasonable steps to satisfy themselves that an investment manager is complying with section 36 of the Pensions Act 1995. Section 36 requires trustees (and any investment manager to whom discretion is delegated) to exercise their powers of investment, among other things, in accordance with regulations.

<sup>93</sup> Above, s 36(1).

<sup>94</sup> Pensions Act 1995, s 33(1)(b).

### **Statement of investment principles (SIP)**

- 4.18 A statement of investment principles is “a written statement of the investment principles governing decisions about investments for the purposes of the scheme”.<sup>95</sup> Under section 35(1), trustees “must secure” that a SIP is “prepared and maintained”, and that it is reviewed and “if necessary, revised”. Under section 36(5), the trustees, or the investment manager to whom any discretion has been delegated, must exercise their powers of investment in accordance with the SIP “so far as reasonably practicable”.
- 4.19 The Investment Regulations provide further detail about the content of a SIP. Under regulation 2(3), the SIP must include a statement of the trustees’ policy on:
- (1) securing compliance with the rules on choosing investments in the pensions legislation;<sup>96</sup>
  - (2) the kinds of investments to be held;
  - (3) the balance between different kinds of investments;
  - (4) risk;
  - (5) the expected return on investments;
  - (6) the realisation of investments;
  - (7) the extent to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments; and
  - (8) the exercise of the rights (including voting rights) attaching to investments.
- 4.20 The fact that trustees are required to state their policy on the extent to which social, environmental or ethical considerations are taken into account when investing does not necessarily mean it is permissible for them to do so. A pensions text suggests that the investment strategy set out in the SIP:

Must accord with the general law ... and be devised to reflect the liability position of the scheme in question.<sup>97</sup>

<sup>95</sup> Pensions Act 1995, s 35(2).

<sup>96</sup> Regulation 2(3)(a) of the Investment Regulations requires that a SIP must state the trustees’ policy for securing compliance with section 36 of the Pensions Act 1995. In particular, section 36(1) requires trustees (and any investment manager to whom discretion has been delegated) to exercise their powers of investment in accordance with regulations. This will include regulation 4 of the Investment Regulations.

<sup>97</sup> Nabarro Pensions Team, *Pensions Law Handbook* (11th ed 2013) para 10.26.

- 4.21 The obligation to review the SIP is clarified by regulation 2(1) of the Investment Regulations,<sup>98</sup> which provides that the SIP must be reviewed “at least every three years” and “without delay after any significant change in investment policy”. Failure to do so exposes the trustees to civil penalties.<sup>99</sup>
- 4.22 Before preparing or revising a SIP, pension trustees must obtain and consider “proper advice”, discussed below. They should also consult with the scheme’s sponsoring employer.<sup>100</sup> Pension trustees may be required to disclose details of any investments that were not made in accordance with the statement of investment principles, giving the reasons why and explaining what action, if any, they propose to take (or have taken) to remedy the position.<sup>101</sup>

### **Proper advice**

- 4.23 Under section 36(3), the trustees must obtain and consider “proper advice” as to whether an investment is satisfactory, taking into account the criteria in regulation 4 of the Investment Regulations and the principles contained in the SIP. For existing investments, trustees should obtain advice periodically, when it is “desirable”.<sup>102</sup>
- 4.24 Section 36(6) states that “proper advice” means advice from someone authorised under FSMA, or the advice:

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

Under section 36(7), trustees will not be taken to have fulfilled their duty to obtain and consider “proper advice” unless the advice was given or confirmed in writing. Failure to comply with the advice requirements exposes trustees to civil penalties.<sup>103</sup>

<sup>98</sup> SI 2005 No 3378.

<sup>99</sup> Pensions Act 1995, s 35(6).

<sup>100</sup> Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 2(2)(b).

<sup>101</sup> See the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 SI 2013 No 2734.

<sup>102</sup> Pensions Act 1995, s 36(4).

<sup>103</sup> Pensions Act 1995, s 36(8).

### **Defined contribution (DC) default funds**

- 4.25 There is more specific guidance about investment strategies for defined contribution default funds. Default funds have always been an important element of DC schemes, and will become even more important following auto-enrolment. All auto-enrolment schemes must include a default fund.<sup>104</sup> The Department for Work and Pensions (DWP) has published detailed guidance on their design, noting that:

The default option should take account of the likely characteristics and needs of the employees who will be automatically enrolled into it. It is likely that employees in the default fund will not be engaged in financial decisions. Decisions will need to be taken for them about their risk profile. As such there should be an appropriate balance between risk and return for the likely membership profile and the charging structure should reflect this balance.<sup>105</sup>

- 4.26 Typically, default funds provide “lifestyle profiles”. Each member is allocated units, and the funds in which these units are invested change as the member nears their retirement date. As retirement approaches, the investments move away from what are typically considered “growth” assets, such as equities, and into what are usually considered more secure assets, such as bonds. An alternative approach is that adopted by providers such as NEST, which at any one time offers a series of retirement date funds. By default, all members retiring in, for example, 2055 are enrolled into the NEST 2055 Retirement Date Fund. The asset allocation of the fund is adjusted as the retirement date approaches.
- 4.27 The guidance also recommends that the design, performance and continued suitability of the default option should undergo a full review at least every three years.<sup>106</sup>
- 4.28 As we discuss in Chapter 9,<sup>107</sup> the Government has announced that it plans to introduce regulations to strengthen trustees’ duties in relation to default funds. The new regulations will specify that default investment strategies must be designed in the interests of members, with a clear statement of aims, objective and structure. In addition, the characteristics and net performance of default investment strategies must be regularly reviewed to ensure alignment with the interests of members.<sup>108</sup>

### **THE PRINCIPLES OF TRUST LAW**

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

<sup>104</sup> Pensions Act 2008, s 17(2)(b).

<sup>105</sup> Department for Work and Pensions, *Guidance for offering a default option for defined contribution automatic enrolment pension schemes* (May 2011) para 15.

<sup>106</sup> Above, para 23.

<sup>107</sup> See para 9.30 below.

<sup>108</sup> Better workplace pensions: Further measures for savers (2014) Cm 8840 p 12.

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

The traditional trust is one under which the settlor, by way of bounty, transfers property to trustees to be administered for the beneficiaries as the objects of his bounty. ... The beneficiaries have given no consideration for what they receive. ... A pension scheme is quite different. Pension benefits are part of the consideration which an employee receives in return for the rendering of his services. ... Beneficiaries of the scheme, the members, far from being volunteers have given valuable consideration. The company employer is not conferring a bounty. In my judgment, the scheme is established against the background of such employment and falls to be interpreted against that background.<sup>109</sup>

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

It is in any event wrong to lift wholesale the detailed rules developed in the context of traditional trusts and then seek to apply them to trusts of quite a different kind. In the modern world the trust has become a valuable device in commercial and financial dealings. The fundamental principles of equity apply as much to such trusts as they do to the traditional trusts in relation to which those principles were originally formulated. But in my judgment it is important, if the trust is not to be rendered commercially useless, to distinguish between the basic principles of trust law and those specialist rules developed in relation to traditional trusts which are applicable only to such trusts and the rationale of which has no application to trusts of quite a different kind.<sup>110</sup>

- 4.32 One author has noted that the fact that pension scheme members are not passive objects of a bounty “must influence the attitude of the courts towards the obligations of trustees”.<sup>111</sup> It is therefore important to interpret trust law flexibly: there is an element of judgement in deciding how far a non-pensions case is relevant to a pensions context.

<sup>109</sup> [1991] 1 WLR 589 at 597.

<sup>110</sup> [1996] AC 421 at 435.

<sup>111</sup> D Pollard, *The Law of Pension Trusts* (1st ed 2013) para 2.13.

### **The meaning of “best interests”**

- 4.33 It is often said that trustees must act “in the best interests of members and beneficiaries”. This phrase appears in the case law, in the Investment Regulations,<sup>112</sup> and in the IORP Directive.<sup>113</sup> However, it has no statutory definition. Its meaning is discussed in a small number of cases, of which the most significant is *Cowan v Scargill*.<sup>114</sup> As we discuss below, this is a particularly difficult case which has generated considerable controversy. We also outline the few other cases which interpret its meaning.

### **Cowan v Scargill**

#### ***The case***

- 4.34 *Cowan v Scargill* was a dispute between the trustees of a mineworkers’ pension scheme. Five trustees appointed by the National Union of Mineworkers (NUM) refused to approve an investment plan unless it was amended to prohibit investments in overseas companies or in oil and gas. The other trustees claimed that this was a breach of fiduciary duty. The leading NUM trustee, Arthur Scargill, argued the case in person. He said that such investments were against union policy, would damage the coal industry and would be against beneficiaries’ interests.<sup>115</sup> He argued that he could maintain this objection, even if it was to the fund’s financial detriment.<sup>116</sup>
- 4.35 The court held that the NUM trustees were in breach of their duties. Their duty was to put the interests of their beneficiaries first, and normally this meant their best financial interests.<sup>117</sup> The court recognised there may be circumstances in which financially disadvantageous arrangements may be in the beneficiaries’ best interests, but the burden of proving this would rest very heavily on the trustees.<sup>118</sup> Further, trustees should not be influenced by their personal views and may even have to act dishonourably (although not illegally) to obtain the best result for their beneficiaries.<sup>119</sup>
- 4.36 On the facts, the court found that the proposed exclusion of certain investments was not in the beneficiaries’ best interests. In particular, the interests of retirees, and the widows and children of deceased miners, differed from the interests of the union and the industry as a whole. The connection between the coal mining industry and the beneficiaries was “too remote and insubstantial”,<sup>120</sup> so the trustees should not have based their investment decisions on the effect on the industry.
- 4.37 Sir Robert Megarry VC stated the applicable law:

<sup>112</sup> Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 4(2).

<sup>113</sup> Institutions for Occupational Retirement Provision (IORP) Directive 2003/41/EC, Official Journal L 235 of 23.09.2003 p 10, art 18(1)(a).

<sup>114</sup> [1985] Ch 270.

<sup>115</sup> Above, at 282.

<sup>116</sup> Above, at 284-285.

<sup>117</sup> Above, at 287.

<sup>118</sup> Above, at 288.

<sup>119</sup> Above, at 287-288. See paras 4.53 to 4.56 below.

<sup>120</sup> [1985] Ch 270 at 292.

The starting point is the duty of trustees to exercise their powers in the best interests of the present and future beneficiaries of the trust, holding the scales impartially between different classes of beneficiaries. This duty of the trustees towards their beneficiaries is paramount. They must, of course, obey the law; but subject to that, they must put the interests of their beneficiaries first. When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests. In the case of a power of investment, as in the present case, the power must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risks of the investments in question; and the prospects of the yield of income and capital appreciation both have to be considered in judging the return from the investment.<sup>121</sup>

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

If the investment in fact made is equally beneficial to the beneficiaries, then criticism would be difficult to sustain in practice, whatever the position in theory. But if the investment in fact made is less beneficial, then both in theory and in practice the trustees would normally be open to criticism.<sup>122</sup>

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

I am not asserting that the benefit of the beneficiaries which a trustee must make his paramount concern inevitably and solely means their financial benefit, even if the only object of the trust is to provide financial benefits. Thus if the only actual or potential beneficiaries of a trust are all adults with very strict views on moral and social matters, condemning all forms of alcohol, tobacco and popular entertainment, as well as armaments, I can well understand that it might not be for the "benefit" of such beneficiaries to know that they are obtaining rather larger financial returns under the trust by reason of investments in those activities than they would have received if the trustees had invested the trust funds in other investments. The beneficiaries might well consider that it was far better to receive less than to receive more money from what they consider to be evil and tainted sources. "Benefit" is a word with a very wide meaning, and there are circumstances in which arrangements which work to the financial disadvantage of a beneficiary may yet be for his benefit ... . But I would emphasise that such cases are likely to be very rare ... .<sup>123</sup>

<sup>121</sup> [1985] Ch 270 at 286-287.

<sup>122</sup> Above, at 287.

<sup>123</sup> [1985] Ch 270 at 288.

### **The debate**

- 4.40 *Cowan v Scargill* has sparked great debate.<sup>124</sup> It has been taken to support the view that the maximisation of value and yield should drive investment decisions.<sup>125</sup> There has been discussion over whether the statement in *Cowan* that “the best interests of the beneficiaries are normally their best financial interests”<sup>126</sup> could be seen as precluding pension schemes from taking into account environmental, social and governance issues when making investment decisions.<sup>127</sup>
- 4.41 In 2005, Freshfields Bruckhaus Deringer published a report commissioned by the Asset Management Working Group of the United Nations Environment Programme Finance Initiative (UNEP FI).<sup>128</sup> The UNEP FI had asked Freshfields to investigate whether the integration of ESG issues into investment policy is “voluntarily permitted, legally required or hampered by law and regulation”, and to identify any common misconceptions against such integration.<sup>129</sup>
- 4.42 The Freshfields Report concluded that *Cowan v Scargill* was “not a reliable legal authority”.<sup>130</sup> Scargill “represented himself”, so the case was “not properly argued” and it should be “limited to its particular facts”.<sup>131</sup> Freshfields quote a lecture given by Sir Robert Megarry VC after he decided *Cowan v Scargill*, in which he described it as “a dull case” that should not be taken as saying profit must be maximised at all costs.<sup>132</sup> The report comments that, read carefully, the case merely confirms that fiduciary powers must be exercised “carefully and fairly for the purposes for which they are given and not so as to accomplish any ulterior purpose”.<sup>133</sup>

<sup>124</sup> See, for example, P Watchman, J Anstee-Wedderburn and L Shipway, “Fiduciary duties in the 21st century: a UK perspective” (2005) 19(3) *Trust Law International* 127 at 127 where it was stated that the view that profit maximisation is the fundamental fiduciary duty is “based on a fundamental misunderstanding of the law” and should not be followed. See also S Hulme, “The basic duty of trustees of superannuation trusts - fair to one, fair to all?” (2000) 14(3) *Trust Law International* 130 and X Frostick, “Is there a duty to act in the best interests of the beneficiaries?” (2000) 83(Feb) *Pension Lawyer* 2.

<sup>125</sup> R Thornton, “Ethical Investment: a case of disjointed thinking” (2008) 67(2) *Cambridge Law Journal* 396 at 398.

<sup>126</sup> [1985] Ch 270 at 287.

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

<sup>128</sup> The UNEP FI is a global partnership between the United Nations Environment Programme and the financial sector.

<sup>129</sup> Freshfields Bruckhaus Deringer, *A legal framework for the integration of environmental, social and governance issues into institutional investment* (2005) p 6.

<sup>130</sup> Above, p 89.

<sup>131</sup> Above, p 89.

<sup>132</sup> Above, p 9.

<sup>133</sup> Above, p 89.

- 4.43 This was also the view of Lord Nicholls. Commenting extra-judicially, he thought that the duty to act in the beneficiaries' best interests was a formulation in different words of a trustee's duty to promote the purpose for which the trust was created.<sup>134</sup> In the Consultation Paper we commented that this was a helpful interpretation.

#### **Other relevant cases**

##### ***Martin v City of Edinburgh District Council***

- 4.44 In the Scottish case of *Martin v City of Edinburgh District Council*,<sup>135</sup> a group of councillors challenged the decision of Edinburgh District Council to disinvest its trust funds from South Africa at the time of the apartheid regime. This followed the Council's policy to be "an apartheid-free authority" in all its dealings.
- 4.45 The Court of Session found that the Council had failed in its duty as trustee. This was not because the decision to disinvest in South Africa was necessarily wrong, but because the Council had made the decision in the wrong way. The Council had applied a pre-existing policy: it did not consider whether it was in the best interests of the beneficiaries or seek professional advice on the issue.<sup>136</sup> Lord Murray held that "trustees have a duty not to fetter their investment discretion for reasons extraneous to the trust purpose, including reasons of a political or moral nature".<sup>137</sup>
- 4.46 Notably, the court explicitly reached this conclusion on "the general principles of law applicable to trusts in Scotland" and not on *Cowan*, should this differ.<sup>138</sup> However, in a non-binding comment as to the meaning of *Cowan*, Lord Murray stated that:

I accept that the most profitable investment of funds is one of a number of matters which trustees have a duty to consider. But I cannot conceive that trustees have an unqualified duty ... simply to invest trust funds in the most profitable investment available. To accept that without qualification would, in my view, involve substituting the discretion of financial advisers for the discretion of trustees.<sup>139</sup>

<sup>134</sup> Lord Nicholls, "Trustees and their Broader Community: Where Duty, Morality and Ethics Converge" (1996) 70 *Australian Law Journal* 205 at 211.

<sup>135</sup> [1989] Pens LR 9, 1988 SLT 329.

<sup>136</sup> [1989] Pens LR 9 at [24], [32], 1988 SLT 329 at 331-2, 334.

<sup>137</sup> [1989] Pens LR 9 at [33], 1988 SLT 329 at 334.

<sup>138</sup> [1989] Pens LR 9 at [32], 1988 SLT 329 at 333, by Lord Murray.

<sup>139</sup> [1989] Pens LR 9 at [33], 1988 SLT 329 at 334.

- 4.47 Lord Murray recognised that it may not be possible for a trustee to “divest himself of all personal preferences, of all political beliefs, and of all moral, religious or other conscientiously held principles”.<sup>140</sup> Nevertheless, they must do their “best to exercise fair and impartial judgment” in the interests of the beneficiaries.<sup>141</sup> Trustees should genuinely apply their minds to the merits of a particular trust decision and, if they are not able to exercise fair and impartial judgment, must abstain from participating in deciding the issue.

***Harries v Church Commissioners***

- 4.48 In *Harries v Church Commissioners*<sup>142</sup> the Bishop of Oxford and other members of the clergy challenged the investment policy of the Church Commissioners who managed the substantial trust funds of the Church of England. They claimed the commissioners attached undue importance to financial considerations in making investment decisions and failed to take into account the underlying purpose for which the assets were held – the promotion of the Christian faith.
- 4.49 The court held that although the commissioners were in law a charity, the purpose of the trustees’ investment powers was to make money: “most charities need money and the more of it there is available, the more the trustees can seek to accomplish”.<sup>143</sup> Charitable trustees could restrict investments which conflicted with the work of a charity; for example, a cancer charity could refuse to invest in tobacco. They could also exclude investments which would alienate their supporters. But trustees should not lose sight of the purpose of their investment powers.<sup>144</sup> They should not make financially detrimental investment decisions based on moral concerns where there were differing views among their supporters.
- 4.50 On the facts, the commissioners operated an “ethical” policy, which excluded around 13% of listed UK companies (by value), including alcohol, tobacco and armaments firms. The judge, Sir Donald Nicholls VC, found that the trustees did not err in law by adopting this ethical policy. On the other hand, the claimants’ proposed plan would have excluded around 37% of listed UK companies. The judge commented:

Not surprisingly, the commissioners’ view is that a portfolio thus restricted would be much less balanced and diversified, and they would not regard it as prudent or in the interest of those for whom they provide.<sup>145</sup>

<sup>140</sup> Above.

<sup>141</sup> Above.

<sup>142</sup> [1992] 1 WLR 1241.

<sup>143</sup> [1992] 1 WLR 1241 at 1246.

<sup>144</sup> Above, at 1247.

<sup>145</sup> Above, at 1251.

The judge held that, given the “endless argument and debate” over what Christian ethics require, the commissioners were “right not to prefer one view over the other beyond the point at which they would incur a risk of significant financial detriment”.<sup>146</sup>

***Buttle v Saunders: a duty to gazump?***

- 4.51 It is sometimes said that fiduciary duties are concerned with maintaining “the highest standards of probity”.<sup>147</sup> The American judge Chief Justice Cardozo classically stated that:

A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.<sup>148</sup>

- 4.52 However, the case of *Buttle v Saunders*<sup>149</sup> is a reminder that the duty is to act in the interests of the beneficiaries – not to act morally in a general sense. Trustees under a will had entered into negotiations for the sale of trust property. Draft contracts had been prepared but not concluded. At this stage, the trustees received a higher offer but refused it on the basis that they felt honour-bound not to withdraw from the initial negotiations. The beneficiaries challenged this decision. The court held that there may be legitimate circumstances in which trustees could refuse a higher offer, such as the certainty of the original offer. However, on the facts the trustees had only considered the honour of withdrawing from existing negotiations. This was incorrect.

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

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

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

<sup>146</sup> Above, at 1251.

<sup>147</sup> D Hayton, *The Law of Trusts* (4th ed 2003) p 37; see also J Langbein, “The Contractarian Basis of the Law of Trusts” (1995-1996) 105 *Yale Law Journal* 625 at 658.

<sup>148</sup> *Meinhard v Salmon* (1928) 164 NE 545 (NY) at 546.

<sup>149</sup> [1950] 2 All ER 193.

## STATUTORY SCHEMES

### Introduction

- 4.55 In Chapter 2, we noted that many public service pension schemes are set up under statute, rather than a trust. The largest of these is the Local Government Pension Scheme (LGPS), and this is the only one of the main public service pension schemes that holds and invests assets.<sup>150</sup>
- 4.56 [At paragraphs 4.59 to 4.81 of the Fiduciary Duties report, we provide an introduction to the regulations governing the LGPS in England & Wales, and discuss how far the case law on best interests applies to the scheme.]

### CONCLUSION

- 4.57 Pension trustees are subject to a variety of legal duties when making investment decisions. In particular, they must invest the scheme assets in the best interests of scheme members and beneficiaries. The phrase “best interests” is undefined in the Investment Regulations and remains the subject of debate. The case of *Cowan v Scargill* is often cited in support of the view that beneficiaries’ interests will typically be their best financial interests, and that maximisation of value and yield should drive investment decisions. However, many believe that this case would not be interpreted in this way today.

<sup>150</sup> 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.

## CHAPTER 8: CONTRACT-BASED PENSIONS: DUTIES TO ACT IN THE BEST INTERESTS OF MEMBERS

- 8.1 In this Chapter, we look at contract-based pension schemes. We ask how far providers of contract-based pensions are under a duty to act in the best interests of members.
- 8.2 As we saw in Chapter 2, private sector defined benefit (DB) schemes are trust-based.<sup>151</sup> However, workplace defined contribution (DC) schemes may either be set up under trust or under contract. Although both trust and contract-based DC workplace pensions serve the same function, they are governed by different systems of law and regulation.
- 8.3 Here we provide a brief introduction to the legal framework governing workplace contract-based pensions. Although contract-based providers are not subject to the trust-based rules described in Chapter 4, the FCA rules require providers to act in the best interests of clients, providing similar protection in some areas.

### A CONTRACT WITH EACH INDIVIDUAL MEMBER

- 8.4 Employers increasingly use group personal pensions to make pension provision for their employees. The employer chooses the scheme and may make arrangements to collect and pay contributions on behalf of members. However, in legal terms, the scheme is characterised as a contract between each employee and the pension provider. As one textbook notes:

From an employee relations point of view, the arrangements will have the appearance of being a scheme run by the employer, although legally this is a series of individual schemes taken out by each employee.<sup>152</sup>

- 8.5 The provider of a contract-based pension scheme will typically offer a range of funds in which a member may choose to invest. However, under auto-enrolment, the provider cannot compel a choice.<sup>153</sup> All schemes must offer a default fund, to be used in the absence of member choice.

### Unfair terms

- 8.6 The problem with contract terms is that they are written by the provider. It is extremely rare for scheme members to even read the full terms – and if they do, there is little they can do to alter them. Pension schemes, like other consumer financial products, are “adhesion contracts”, offered on a “take it or leave it” basis.

<sup>151</sup> See para 2.5 above.

<sup>152</sup> *Tolley's Pensions Law* (Issue 83, May 2014) para A3.21.

<sup>153</sup> Pensions Act 2008, s 17(2)(b).

- 8.7 The Unfair Terms in Consumer Contracts Regulations 1999<sup>154</sup> provide some protection against unfair terms. Following litigation on bank charges, there has been controversy over how far these regulations permit the courts to assess the fairness of unreasonably high charges.<sup>155</sup> The courts have no jurisdiction to look at price terms (such as annual management charges) which are clearly presented to members. However, if a price term is not in plain and intelligible language, it may be assessed for fairness.
- 8.8 The Law Commission and Scottish Law Commission have recommended that the law should be clarified to state that the price terms are only exempt if they are transparent and prominent.<sup>156</sup> This change is now included in the Consumer Rights Bill, introduced into Parliament in January 2014.<sup>157</sup> This means that, following the reform, the courts will have power to assess the fairness of charges which are presented in such a way that an average consumer would not be aware of them.

## REGULATION

- 8.9 Providers operate in a highly regulated environment, and are subject to oversight by the FCA. They are also subject to supervision by the Prudential Regulation Authority, which considers issues of financial safety and capital liquidity.
- 8.10 The FCA Handbook implements several European directives. For our purposes the most important is the Markets in Financial Instruments Directive (MiFID).<sup>158</sup> This directive is intended to harmonise the provision of investment services to achieve similar regulatory outcomes across member states. It works together with the MiFID Implementing Directive<sup>159</sup> and the MiFID Regulation,<sup>160</sup> collectively known as the “Level 2” legislation. We are aware that a new directive, intended to repeal MiFID and replace it with an updated form (generally known as MiFID 2), is due to be published in the Official Journal of the European Union.

<sup>154</sup> SI 1999 No 2083.

<sup>155</sup> See *Office of Fair Trading v Abbey National plc* [2009] UKSC 6, discussed in detail in Law Commission and Scottish Law Commission, *Unfair Terms in Consumer Contracts: a new approach?*, Issues Paper (July 2012).

<sup>156</sup> Law Commission and Scottish Law Commission, *Unfair Terms in Consumer Contracts: Advice to the Department for Business, Innovation and Skills* (March 2013).

<sup>157</sup> Consumer Rights Bill 2013-14 (HC Bill 180), cl 64(2).

<sup>158</sup> Markets in Financial Instruments Directive 2004/39/EC, Official Journal L145 of 30.4.2004 p 1 (MiFID).

<sup>159</sup> Markets in Financial Instruments Implementing Directive 2006/73/EC, Official Journal L241 of 2.9.2006 p 26 (MiFID Level 2).

<sup>160</sup> Markets in Financial Instruments Directive Regulation 1287/2006/EC, Official Journal L241 of 2.9.2006 p 1.

## **Principles for business**

8.11 FCA rules set out eleven general principles for all authorised persons.<sup>161</sup> Five principles are particularly relevant to the type of protection provided by duties under “judge-made” law:

- (1) A firm must conduct its business with due skill, care and diligence (Principle 2).
- (2) A firm must pay due regard to the interests of its customers and treat them fairly (Principle 6).
- (3) A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading (Principle 7).
- (4) A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client (Principle 8).
- (5) A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment (Principle 9).<sup>162</sup>

8.12 These principles govern all the regulated activities of contract-based pension providers, including the decisions they make as to how to invest member contributions. If the Principles are breached, the FCA may bring an enforcement action. However, individuals have no right of action under the Financial Services and Markets Act 2000 (FSMA) simply for breach of the Principles.<sup>163</sup>

## **Conduct of business rules (COBS)**

### ***Acting honestly, fairly and professionally***

8.13 COBS provide more detail on how these principles should be applied. COBS 2.1.1R contains the regulatory equivalent of the “best interests” duty:

A firm must act honestly, fairly and professionally in accordance with the best interests of its client.

8.14 As we explained in the Consultation Paper, a private person who has suffered loss as a result of a breach of this rule may bring an action for breach of statutory duty under section 138D of FSMA.<sup>164</sup> However, we are not aware that any claims have been successfully brought under COBS 2.1.1.

<sup>161</sup> “Authorised persons” are defined in s 31 of the Financial Services and Markets Act 2000, and include persons who have permission to carry on regulated activities under Part 4A of that Act.

<sup>162</sup> FCA Handbook PRIN 2.1.1R.

<sup>163</sup> FCA Handbook PRIN 3.4.4R. For a discussion of FCA enforcement, the remedies available to private persons under the Financial Services and Markets Act 2000, and consumer redress, see CP 215 paras 8.71 to 8.76 and Appendix B.

<sup>164</sup> CP 215 paras 8.72 to 8.75.

- 8.15 There are restrictions on the extent to which duties and liabilities under the FCA Handbook may be excluded or limited. COBS 2.1.2R states that:

A firm must not, in any communication relating to designated investment business<sup>165</sup> seek to:

- (1) exclude or restrict; or
- (2) rely on any exclusion or restriction of;

any duty or liability it may have to a client under the regulatory system.

- 8.16 Firms will also often owe duties under the general law. For example, providers will have duties to take reasonable care and skill in carrying out the services they have undertaken to provide under the terms of the contract with the member. FCA guidance is that, in order to comply with the “best interests” duty under COBS 2.1.1R, firms:

should not, in any communication to a retail client relating to designated investment business:

- (a) seek to exclude or restrict; or
- (b) rely on any exclusion or restriction of;

any duty or liability it may have to a client other than under the regulatory system, unless it is honest, fair and professional for it to do so.<sup>166</sup>

- 8.17 The above rules are in addition to provisions under the general law which govern the exclusion or limitation of liability.<sup>167</sup>

### ***Disclosure of costs and risks***

- 8.18 Under COBS 2.2.1R, a provider must provide appropriate information in a comprehensible form to a client about:

- (1) the firm and its services;
- (2) designated investments and proposed investment strategies;
- (3) execution venues; and
- (4) costs and associated charges.

<sup>165</sup> “Designated investment business” includes a number of the activities listed in Part 2 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 SI 2001 No 544. The full list is available here: <http://www.fshandbook.info/FS/glossary-html/handbook/Glossary/D?definition=G283>.

<sup>166</sup> FCA Handbook COBS 2.1.3G(1).

<sup>167</sup> See Unfair Terms in Consumer Contracts Regulations 1999 [now replaced by the Consumer Rights Act 2015, part 2].

8.19 COBS 14.3.2R states that:

A firm must provide a client with a general description of the nature and risks of designated investments, taking into account, in particular, the client's categorisation as a retail client or a professional client.<sup>168</sup>

8.20 The purpose of such disclosure is so that a client is reasonably able to understand the nature and risks of the service and the specific type of investment that is being offered and, consequently, to take investment decisions on an informed basis.<sup>169</sup>

### **Unit-linked funds**

8.21 In regulatory terms, the contract between the member and the pension provider is often characterised as a long-term contract of insurance. These “policies” typically offer members the choice of investing in a range of unit-linked funds. The FCA estimates that £900 billion is invested in unit-linked funds, approximately 85% of which is pensions savings.<sup>170</sup>

8.22 Where members invest in unit-linked policies, contributions paid by the member are treated as “premiums” and are used to allocate units to the member in the funds of their choice.<sup>171</sup> The provider owns the assets of each fund and makes the investment decisions for each fund in accordance with its investment objectives. The units held by members in these funds are simply “units of account”; they do not confer any proprietary rights.<sup>172</sup> Unit prices rise and fall to reflect changes in the value of the fund's underlying assets.

### ***Investment: mandate compliance and appropriateness***

8.23 The FCA requires that funds are managed in accordance with the investment mandate, objectives and the disclosures that are made to customers. Furthermore, the assets backing unit-linked policies must be appropriate for customers. Assets which may be used to determine the level of benefits payable in unit-linked policies are known as the “permitted links”.<sup>173</sup>

8.24 The Association of British Insurers (ABI) has produced a “Guide of good practice for unit-linked funds” which builds on these requirements. Firms should ensure they have sufficient information about the assets which their funds are invested in to ensure they meet customer expectations. In particular, the asset description provided to the customer should be consistent with that provided to the investment manager. The ABI's Guide states that:

<sup>168</sup> This rule only applies in relation to the business and activities listed in COBS 14.3.1R. “Designated investments” include a security or a contractually-based investment.

<sup>169</sup> FCA Handbook COBS 2.2.1R.

<sup>170</sup> Financial Conduct Authority, *The governance of unit-linked funds* (October 2013) TR13/8, p 3.

<sup>171</sup> Where the member has chosen more than one fund, their contributions will be split in accordance with their instructions.

<sup>172</sup> *Foskett v McKeown* [2001] 1 AC 102 at 143, by Lord Millett.

<sup>173</sup> See FCA Handbook COBS 21.

Firms should be mindful of their target market and ensure that they conduct sufficient analysis to enable them to make informed decisions about whether assets are appropriate as permitted links.<sup>174</sup>

- 8.25 In addition to the rules on “permitted links”, there are also “close matching rules”. These rules provide that insurance companies must cover their liabilities with, as closely as possible, the assets to which those liabilities are linked.<sup>175</sup>

### ***Exercising discretion***

- 8.26 Providers will often have discretion in relation to the management of funds. This may include the introduction of new charges. Whilst often the exercise of discretion will be subject to the terms and conditions of the contract between the client and the provider, these may not offer clients adequate protection.
- 8.27 Where providers have discretion, it is important that they treat customers fairly.<sup>176</sup> The ABI Guide notes that:

Where possible ... funds should be operated according to published criteria and standards. Specifically, the scope of the firm’s discretion in managing the fund and the limits to that discretion should be documented and disclosed to policyholders and other relevant parties, where appropriate.<sup>177</sup>

### **Suitability**

- 8.28 A firm must “take reasonable steps to ensure that a personal recommendation, or a decision to trade, is suitable for its client”.<sup>178</sup> In order for a firm to make a suitable recommendation or trading decision for its client, it must obtain the necessary information regarding the client’s:

- (1) knowledge and experience in the investment field relevant to the specific type of designated investment or service;

<sup>174</sup> Association of British Insurers, *Guide to Good Practice for Unit-Linked Funds* (May 2014) para 4.21.

<sup>175</sup> FCA Handbook INSPRU 3.1.57R. Alternatively, the insurer may cover its liabilities with a property-linked reinsurance contract, or a combination of both assets and reinsurance contracts.

<sup>176</sup> The FCA Handbook makes this point explicitly in relation to “with-profits” policies, another type of policy used in long-term insurance business. Under these policies, the investor is promised a certain amount of pension in return for contributions, and in addition may be able to participate in the fund’s profits where the fund is, on an actuarial valuation, in surplus. COBS 20.2.3 provides that a firm must have good reason to believe that its pay-outs on individual with-profits policies are fair.

<sup>177</sup> Association of British Insurers, *Guide to Good Practice for Unit-Linked Funds* (May 2014) para 4.8.

<sup>178</sup> FCA Handbook COBS 9.2.1R. COBS 9 is not applicable to “execution only” type business (that is, business which does not involve the provision of advice or the exercise of discretion over investments belonging to others). All firms which provide “investment services” in the course of MiFID business which are not subject to COBS 9 are nonetheless subject to “appropriateness” requirements in COBS 10: FCA Handbook COBS 10.1.1R.

- (2) financial situation; and
  - (3) investment objectives.
- 8.29 In the Consultation Paper, we took the view that pension providers would be subject to the suitability rules under COBS 9.<sup>179</sup> On revisiting the issue, we think this may not be the case. The rules in COBS 9 apply only to firms which make personal recommendations in relation to designated investments,<sup>180</sup> or that manage investments.<sup>181</sup> Contract-based pension schemes typically own the assets of the scheme themselves, and so will not fall within the regulatory definition of “managing investments” which requires that the assets belong “to another”.<sup>182</sup>
- 8.30 However, independent financial advisers (IFAs) are under suitability requirements if they recommend contract-based schemes to clients. In the Consultation Paper we discussed a series of cases in which IFAs had been found liable for mis-selling pension schemes, in breach of suitability rules.<sup>183</sup> We noted that the courts tended to interpret an adviser’s duty of care in line with the regulator’s suitability rules.

***The emphasis on point of sale***

- 8.31 The emphasis of the FCA Handbook is on ensuring that clients are fully aware of the costs and risks of products at the point of sale.<sup>184</sup> Under COBS 14.2.1R, a firm that sells a personal or stakeholder pension scheme to a retail client must provide a key features document and a key features illustration. According to the rules, a key features document:

must include enough information about the nature and complexity of the product, how it works, any limitations or minimum standards that apply and the material benefits and risks of buying or investing for a retail client to be able to make an informed decision about whether to proceed.<sup>185</sup>

The document must explain the arrangements for handling complaints about the product, the availability of any compensation under the Financial Services Compensation Scheme, and details of any rights to cancel or withdraw.<sup>186</sup>

- 8.32 Consultees emphasised to us that the requirements under FCA rules are concerned with “point of sale”, rather than ongoing suitability over time. Towers Watson put the point as follows:

<sup>179</sup> CP 215 para 12.19.

<sup>180</sup> FCA Handbook COBS 9.1.1R.

<sup>181</sup> FCA Handbook COBS 9.1.3R.

<sup>182</sup> Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 SI 2001 No 544 art 37.

<sup>183</sup> See *Loosemore v Financial Concepts* [2001] Lloyd’s Rep PN 235 and *Gorham v British Telecommunications plc* [2000] 1 WLR 2129, discussed at CP 215 paras 11.65 to 11.68.

<sup>184</sup> This is in addition to the disclosure required by the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 SI 2013 No 2734.

<sup>185</sup> FCA Handbook COBS 13.3.1R(1).

<sup>186</sup> FCA Handbook COBS 13.3.1R(2).

The FCA regulates these DC providers and its oversight is intended to ensure that sales of financial products occur with the consumer having a full understanding of the product at the point of sale.

8.33 Towers Watson explained that under auto-enrolment, there was no “point of sale” at which the consumer can be demonstrated to have understood the terms and conditions of the product. They noted that because of the uncertain nature of pension outcomes, a static product which satisfies “point of sale” tests would either be too complex to explain or too simple to be effective.

8.34 The National Association of Pension Funds shared these concerns:

While an approach centred on point-of-sale might make a lot of sense for many retail products where the product is either simple or can be changed annually, pension savings products need to be looked at differently.

***Emphasis on product design rather than individual suitability***

8.35 In the Consultation Paper we commented that there appeared to be no clear rule requiring providers to review the suitability of a scheme over time.<sup>187</sup> In so far as the FCA does recognise a duty to review products, the emphasis is on the overall suitability of the product for its target market, rather than its suitability for an individual member. For example, a product designed and marketed as a default fund should remain suitable as a default fund. The FCA has produced guidance on post-sale responsibility that states that firms:

should periodically review products whose performance may vary materially to check whether the product is continuing to meet the general needs of the target audience that it was designed for, or whether the product's performance will be significantly different from what the provider originally expected and communicated to the distributor or customer at the time of the sale ... . If this occurs, the provider should consider what action to take, such as whether and how to inform the customer of this (to the extent the customer could not reasonably have been aware) and of their option to seek advice, and whether to cease selling the product.<sup>188</sup>

<sup>187</sup> CP 215 para 12.20. COBS 9.2.5R states that a firm is entitled to rely on the information provided by its clients “unless it is aware that the information is manifestly out of date, inaccurate or incomplete”. Respondents commented that this did not require pension providers to contact members to ask about changes in circumstances.

<sup>188</sup> Financial Conduct Authority, *The Responsibilities of Providers and Distributors for the Fair Treatment of Customers (RPPD)* (April 2013) para 1.21. The FCA stresses that this is only guidance, and that it need not be followed in order to achieve compliance with rules or other requirements. However, if a person acts in accordance with the guidance in the circumstances contemplated by the guidance, then the FCA will not take action against that person in relation to the aspects of the rules to which the guidance relates: see para 1.3.

### **Default funds**

- 8.36 For default funds in auto-enrolment schemes, the Department of Work and Pensions (DWP) has published guidance which states that:

The design, performance and continued suitability of the default option and its investment strategy should undergo a full review by the designated party at least every three years.<sup>189</sup>

- 8.37 DWP state that the review should look at governance arrangements and objectives; the suitability of the charge level; the investment strategy of the option; the performance of individual fund components; and whether the performance of individual components is consistent with the overall objective of the default option.<sup>190</sup> However, this guidance does not have regulatory force.

### **THE ROLE OF THE EMPLOYER**

- 8.38 In a contract-based pension scheme, the employer chooses the scheme but has no ongoing responsibility for monitoring the performance of the scheme.<sup>191</sup> Instead, the responsibility of the employer is often limited, where direct payment arrangements are in place,<sup>192</sup> to making direct contributions to the pension provider on behalf of the member.<sup>193</sup>

- 8.39 It is arguable that employers may owe their current employees some obligations arising from the duty of mutual trust and confidence that exists between employers and employees. However, as the Investment Sub-Committee of the Association of Pension Lawyers noted in its written evidence to the Work and Pensions Select Committee:

This duty is likely to be fairly limited, and would likely not extend, for example, to monitoring the suitability of investments in the contract-based scheme once the scheme had been established. Once an employee leaves active service the employer has no role whatsoever. Employers cannot require employees to move funds built up from past contributions, as to do so will border on advice, which the employer in most cases will not be qualified or authorised to give.<sup>194</sup>

<sup>189</sup> Department for Work and Pensions, *Guidance for offering a default option for defined contribution automatic enrolment pension schemes* (May 2011) para 23.

<sup>190</sup> Above, para 26.

<sup>191</sup> Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014) para 3.14.

<sup>192</sup> These are arrangements between the member and the employer under which contributions fall to be paid by the employer towards the scheme. Such arrangements will exist where the employer arranges to make employer contributions to a personal pension scheme and/or where the employer arranges to deduct the member's contributions from pay and to pay them across to the pension scheme for the member.

<sup>193</sup> Improving governance and best practice in workplace pensions, Sixth Report of the Select Committee on Work and Pensions (2012-13) HC 768-II at Ev 135.

<sup>194</sup> Improving governance and best practice in workplace pensions, Sixth Report of the Select Committee on Work and Pensions (2012-13) HC 768-III at Ev w5.

- 8.40 Where direct payment arrangements are in place, employers are under certain obligations to consult their employees about reductions in the employer's contributions or increases in the employees' contributions.<sup>195</sup> However, the relevant regulations do not apply to an employer in relation to a personal pension scheme where no employer contributions fall to be paid towards the scheme,<sup>196</sup> nor do they apply to an employer with fewer than 50 employees.<sup>197</sup>

### **Voluntary governance arrangements**

- 8.41 Some employers who offer personal pension schemes to their workers have chosen to put additional voluntary governance arrangements in place. In July 2013, The Pensions Regulator (TPR) published guidance for those employers that wished to establish "management committees" as a way of monitoring their schemes.<sup>198</sup> TPR recommended that any committee should focus on key areas. These include monitoring costs and charges and reviewing the default fund. TPR comments that where members have actively chosen their investments, management committees should ensure that they are regularly informed how important it is to review the suitability of their investment choices.<sup>199</sup>
- 8.42 Employer-level governance arrangements are now fairly common. Research carried out by TPR in 2008 found that approximately half of employers offering personal pensions have some form of governance arrangement over and above that legally required, ranging from ad hoc reviews of the scheme to formal management committees.<sup>200</sup> However, as DWP has noted:

While such arrangements can work well, they will not be practical or economic for all employers, particularly small ones.<sup>201</sup>

### **INDEPENDENT GOVERNANCE COMMITTEES**

- 8.43 Employers' voluntary arrangements cannot necessarily fill the "governance gap" within contract-based schemes. A series of recent reports have identified a problem with the lack of a single identifiable entity with ongoing responsibility for considering whether contract-based schemes are run in members' interests.<sup>202</sup> DWP has noted that:

<sup>195</sup> Pensions Act 2004, s 260. The relevant regulations are the Occupational and Personal Pension Schemes (Consultation by Employers and Miscellaneous Amendment) Regulations SI 2006 No 349.

<sup>196</sup> Occupational and Personal Pension Schemes (Consultation by Employers and Miscellaneous Amendment) Regulations SI 2006 No 349, reg 5.

<sup>197</sup> Above, reg 3(2A)(c).

<sup>198</sup> The Pensions Regulator, *Monitoring your pension scheme: Management committees for employers* (July 2013).

<sup>199</sup> Above, p 5.

<sup>200</sup> Department for Work and Pensions, *Quality standards in workplace defined contribution pension schemes: Call for evidence* (July 2013) para 27.

<sup>201</sup> Above, para 28.

<sup>202</sup> See, for example, Improving governance and best practice in workplace pensions, Sixth Report of the Select Committee on Work and Pensions (2012-13) HC 768-I; Better workplace pensions: Further measures for savers (2014) Cm 8840 p 17.

Without any body with this overall responsibility, including beyond the point of sale, it is not clear whether and how conflicts of interest are identified and addressed and who is ensuring that decisions are taken in the interest of members of the scheme.<sup>203</sup>

- 8.44 In September 2013, the Office of Fair Trading (OFT) published a market study into DC workplace pensions.<sup>204</sup> The OFT noted that contract-based providers “do not have a recognised equivalent of the trustee board that is ultimately accountable for representing the needs of scheme members”.<sup>205</sup> Without strong governance, “providers may not have the incentive and ability to address high charges, poor administration, poor performance and outdated or unsuitable investment strategies”.<sup>206</sup>
- 8.45 Some providers, such as Legal & General, had already established governance committees. In response to the OFT’s concerns, the ABI agreed to embed Independent Governance Committees (IGCs) within all providers of contract-based pension schemes.<sup>207</sup>
- 8.46 In March 2014 the Government announced that, from April 2015, all providers of contract-based pensions will be required to operate IGCs to assess the value for money delivered by these schemes and report on how they meet quality standards.<sup>208</sup>

#### **DO FIDUCIARY DUTIES APPLY TO CONTRACT-BASED PENSIONS?**

- 8.47 In the Consultation Paper, we noted that in discussions stakeholders had consistently said that while trustees were subject to fiduciary duties, contract-based pension providers were not. We commented that, in our view, this was an oversimplification.

#### **Complex duties**

- 8.48 We believe the position is more complex. Whilst, like trustees, contract-based pension providers are in a position to affect the interests of vulnerable members, this may be insufficient to ground a fiduciary duty in itself. As noted in Chapter 3,<sup>209</sup> the courts have adopted a variety of approaches in determining whether a fiduciary relationship arises on the facts of a case. We think a court is likely to look at whether a member has a *legitimate* expectation that the provider will act in the member’s interests. In many cases, the contract terms will mean that such an expectation will not be legitimate, even if it arises at all.

<sup>203</sup> Department for Work and Pensions, *Quality standards in workplace defined contribution pension schemes: Call for evidence* (July 2013) para 25.

<sup>204</sup> Office of Fair Trading, *Defined contribution workplace pension market study* (September 2013, revised February 2014).

<sup>205</sup> Above, para 7.33.

<sup>206</sup> Above, para 7.34.

<sup>207</sup> Above, para 7.52.

<sup>208</sup> Better workplace pensions: Further measures for savers (2014) Cm 8840, p 10.

<sup>209</sup> See paras 3.16 to 3.24 above.

- 8.49 However, whilst they may not owe fiduciary duties, contract-based pension providers will owe other, “fiduciary-like” duties. As we have seen, COBS 2.1.1R requires firms “to act honestly, fairly and professionally in accordance with the best interests of its client”. Where a private person has suffered loss through a breach of this rule, they may bring an action under section 138D of the Financial Services and Markets Act 2000.<sup>210</sup>
- 8.50 Furthermore, contract providers owe duties to take reasonable care and skill in carrying out the services they have undertaken to provide under the terms of the contract. Similarly, when the provider has a discretion, the exercise of that discretion is unlikely to be unfettered. In *Paterson Arran Ltd Group Personal Pension Scheme*,<sup>211</sup> the Deputy Pensions Ombudsman considered the basic principles that the administrator of a scheme must follow in coming to a decision regarding the discretionary distribution of a death benefit:
- (1) they must ask correct questions;
  - (2) they must direct themselves properly in law; in particular they must adopt a correct construction of the scheme rules;
  - (3) they must take into account all relevant factors, but no irrelevant factors;
  - (4) they must not arrive at a perverse decision, ie a decision to which no reasonable body could arrive.<sup>212</sup>

#### **The contract model and auto-enrolment**

- 8.51 That said, there are serious problems with the law relating to contract-based pensions. The contract model assumes that savers are fully informed autonomous parties, able to make good judgements in the market place. Yet the evidence is that savers fail to engage with pensions. This has now become institutionalised by auto-enrolment, where people are placed in pension schemes by default, without any conscious agreement to the charges or contract terms.
- 8.52 As we explore in Chapter 9 [of the Fiduciary Duties report], this leads to a lack of effective controls on high costs and charges. Schemes are chosen by employers, who may lack both the incentive and the skill to form complex judgements over charges that are paid for by the members. In trust-based schemes trustees are expected to make informed decisions on behalf of their members. Until now, there is no equivalent person within the contract system with a clear duty to monitor charges and costs.

<sup>210</sup> CP 215 paras 8.72 to 8.75.

<sup>211</sup> Ref 80843/1 (27 April 2011).

<sup>212</sup> *Paterson Arran Ltd Group Personal Pension Scheme* Ref 80843/1 (27 April 2011) para 27. See also *Standard Life Pension* Ref 74745/1 (30 September 2009); *Scottish Equitable Personal Pension Scheme* Ref 73461/1 and 75033/1 (25 June 2009).

- 8.53 There is also a lack of a clear duty on providers to monitor ongoing suitability over time. For default funds this is partially addressed by DWP guidance, though until now this has not had regulatory force. The problem also applies to chosen funds: an individual may choose to invest in a relatively risky equities fund in their 20s or 30s, and then forget all about it. The scheme may not still be suitable for them several decades later as they approach retirement. Contract-based providers are not required to review member choices, and even if they do they may lack the power to change contract terms without members' express agreement. Such agreement may not be forthcoming.
- 8.54 Finally, we have considered whether contract-based pension schemes are subject to the same rules as trustees, when it comes to taking ethical issues into account. How far are contract-based providers required to consider risks to the long-term sustainability of companies in which they invest? And how far may contract-based default funds apply generally prevailing ethical standards? In contract-based schemes, this is likely to be considered as part of a duty of care, rather than a more general duty to act in a beneficiary's best interests, and there is even less guidance than for trustees. Given that trust-based and contract-based default funds perform the same function, we think that the law should seek to achieve similar outcomes. Both regulators have said that they have similar expectations for scheme quality and member outcomes.<sup>213</sup> In Chapter 9 we note that DWP aims to ensure minimum standards across the DC workplace market.

## **CONCLUSION**

- 8.55 There is widespread concern that workplace DC pensions do not always operate in the best interests of savers. Although these problems apply to both trust-based and contract-based schemes, they are particularly acute in contract-based schemes which do not have an equivalent of the trustee board to represent the needs of scheme members.
- 8.56 The contract model assumes that savers are autonomous parties, able to make informed judgements in the market place. This is unsuited to a system in which savers fail to engage with pensions and are often placed in pensions schemes by default, without agreeing to the charges or the terms.
- 8.57 From April 2015, contract-based pension providers will be required to establish IGCs to assess the value for money delivered by these schemes and report on how they meet quality standards. We think that IGCs will be central to establishing a system which can be used with auto-enrolment, to provide value for money and investment strategies in the best interests of savers. It is vital that IGCs are made to work.

<sup>213</sup> Financial Conduct Authority and The Pensions Regulator, *Guide to the regulation of workplace defined contribution pensions* (March 2014) p 2. See also Better workplace pensions: Further measures for savers (2014) Cm 8840, p 5.

## APPENDIX A

### “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.<sup>1</sup>

- 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.<sup>3</sup>

##### **DUTIES OF PENSION TRUSTEES**

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

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

<sup>2</sup> *Fiduciary Duties of Investment Intermediaries* (2014) Law Com No 350. This is available at [http://lawcommission.justice.gov.uk/areas/fiduciary\\_duties.htm](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.

<sup>3</sup> *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:

- (5) trustees should have good reason to think that scheme members would share the concern; and
- (6) 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.<sup>4</sup> 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.<sup>5</sup> 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:
- (7) where the decision is expressly permitted by the trust deed; and
  - (8) 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.

<sup>4</sup> Unless the trust instrument provides otherwise.

<sup>5</sup> *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.<sup>7</sup> 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.

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<sup>6</sup> Fiduciary Duties of Investment Intermediaries (2014) Law Com No 350 paras 6.91 to 6.98.

<sup>7</sup> Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378, reg 2(3).