NAPF

Securing the future of pensions

Law Commission review of fiduciary duties of investment intermediaries

The NAPF's preliminary response

October 2013

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Overview

- From our discussions with NAPF members and their advisers we are of the view that the fiduciary duties of trustees of pension plans are reasonably clearly understood. Trustees understand that their duty is to act in the best interests of members, which vary somewhat depending on whether the members have defined benefit or defined contribution arrangements. The members' interests in the pensions context will be primarily, but not solely financial. There are many situations in which an investment presenting attractive short-term financial gain will not be in the members' interests, and there is sufficient scope under current law as currently understood for trustees to take a longer term view.

- There is widespread agreement that a governance vacuum and information asymmetry can lead to suboptimal outcomes for members of contract-based pension arrangements. There does not seem to be a consensus, however, that the assignment of a fiduciary duty to various players in this market would improve the situation. Whilst there is agreement that providers and employers should be charged with a clear duty of care when making decisions affecting members, neither have sufficient discretion to act over the life of a pension investment – employers' duties to members end when the member moves from that employer's employment, and providers seldom have sufficient latitude under the law to depart from the choices made by the member or his employer. Therefore, imposition of a fiduciary relationship would be inappropriate.

- We believe that much of the apprehension concerning contract-based schemes could be addressed more directly through clear standards of conduct applicable to employers and providers in those areas in which they exercise discretion. With the right governance arrangements, contract-based schemes can lead to good member outcomes; in these arrangements, good governance of pension arrangements is a logical extension of the employer's current legal duty of good faith. However, governance requires a level of employer engagement that can often be lacking. A clear requirement or statement of expectation regarding governance at employer level would be helpful.

- Generally, we believe that the debate concerning fiduciary duty engendered by the Kay report is helpful inasmuch as it may clear the air about the role of fiduciary concepts in pension scheme management. However, the problems cited in the report are not likely to be resolved through extension or redefinition of fiduciary duties. Much of the short-termism in investment is due to other factors, such as a desire to minimise the effect of pension deficits on company balance sheets; a lack of suitable investment vehicles for trustees; a difficulty in quantifying intangibles such as potential environmental impacts and the absence of quality information to inform an educated debate engagement on possible longer term risks.

About the NAPF

The NAPF is the leading voice of workplace pensions in the UK, speaking for 1,300 pension schemes with some 16 million members and assets of around £900 billion. NAPF members also include over 400 businesses providing essential services to the pensions sector.

PART A – Pension fund trustees

1. **Is fiduciary duty sufficiently clearly understood? How do pension fund trustees view their fiduciary duties? Does a narrow interpretation prevent consideration of broader environmental, social or ethical factors within the investment strategy?**

We are reasonably certain, after discussions with interested members, that trustees of pension funds understand that they are required to put the interests of the beneficiaries of the pension fund first, and to avoid or manage conflicts of interest. Whilst there is a general appreciation that they have been asked as a primary duty to safeguard and pursue the members' financial interests, few trustees believe that financial interests are the sole concern – fairness between members, administrative standards and other matters are also important. Moreover, there is an increasing trend towards accepting that stewardship, and the consideration of environmental, social and governance ("ESG") issues, should be viewed as financial in nature and therefore within the trustees' remit when evaluating current and potential investments.

We also recognise that a range of investors have a desire to reflect their values in their investment portfolios. These are often referred to as "socially responsible investors" ("SRI"s) or "ethical investors" who generally advocate an approach that combines investment returns with a moral or ethical role for investing. This additional dimension is generally not driven by financial considerations but is there to ensure that the investment portfolios are congruent with the investors' beliefs and values. We do not believe that active consideration of such matters is or should be among the explicit duties of pension fund trustees. Such an approach would not necessarily be aligned with their primary objective of acting in the best financial interests of members and could in fact lead to conflicts of interest, which must be avoided where possible.

Even in circumstances where trustees can agree that consideration of ethical, moral or other preferences is appropriate, application of purely ethical considerations can become divisive and very political. It is difficult to develop a consensus view among trustees in order to establish a clear policy. Distilling the disparate views of the broader membership into a clear policy would be more difficult still and trustee boards will not wish to deflect focus from factors that more directly influence financial growth. It may be that the court's emphasis in *Cowan v Scargill* that trustees must largely put aside personal moral and ethical beliefs provides some cover for those who would prefer not to tread in such a rocky area, but we doubt that it is the primary reason that trustees decide to exclude ethical considerations from their investment deliberations.

We would instead distinguish purely ethical concerns from those that are at heart financial in nature, such as ESG considerations, which can significantly affect a company's long-term value, reputation, brand growth rate, margins, market share and borrowing costs. It is the NAPF's view that ESG considerations (or as they are increasingly called, "extra-financial" considerations) have a current or potential impact on an investment's

performance, whether from the point of view of return, liquidity or capital value. Therefore, it is wholly consistent with a trustees' fiduciary duty to take ESG considerations into account.

We believe that this view is increasingly recognised by trustee boards. Indeed in response to our 2012 annual survey of pension funds' engagement with investee companies, over 90% of respondents agreed that institutional investors (including pension funds) have stewardship responsibilities that include engaging with companies and voting. Whilst stewardship activities can be prohibitively expensive at the fund level, trustees are more frequently delegating the day to day responsibility for stewardship to their investment managers, a model recognised by the UK Stewardship Code. The fund managers are then asked to report back to the trustees on these matters as part of their performance reporting. There is evidence that demand for such information from investment advisers is also slowly growing.

We are inclined to believe that the problem that the Kay report has identified – that trustees appear to pursue the short-term financial interests of the fund (in the case of a defined benefit context) or members (in a defined contribution context), has its source elsewhere, even though there may be some loose talk about fiduciary duty mixed in when the problems are explained.

Adoption of a longer term approach in the defined-benefit context is more likely to be constricted by the requirement that volatility be minimised in order to ensure that the sponsor's balance sheets are not overly affected by market changes in the recorded pension's deficit. In the defined-contribution context, members may become discouraged if they do not see their assets grow as expected year-on-year and may or may not understand that these assets are being invested with an eye to long-term returns at retirement age (where, indeed, the scheme is large enough to engage in different strategies for members of differing ages). This latter point is an important one, especially as we discuss the responsibility of employers and providers.

Our recently published (May 2013) Responsible Investment Guide states (and this is echoed in our Principles for Stewardship Best Practice) that pension funds should develop an investment policy that includes an understanding of stewardship objectives and risks. This policy should encourage the consideration of financially material extra-financial risks (eg ESG factors) when making investment decisions and the exercising of stewardship responsibilities such as engagement and voting. Building on this, pension funds should select investment managers, across all asset classes, who act as responsible investors and hold them to account for adhering to the fund's own policy and expectations.

We are unconvinced that it would be appropriate to impose a more explicit duty to consider specific factors when devising an investment strategy. There are a number of considerations that go into any investment instruction attempting to put a name to all of them would be a Sisyphean task, and to name only some would give undue prominence to those named. Such an approach would also be a hindrance to trustees' ability (and duty) to use their judgement, taking all considerations into account and could be at odds with the stated purposes of some pension trusts. Additionally, pension trustees should not be directed, explicitly or implicitly, to invest in assets which the market has priced unappealingly, nor in which politicians would like to see more investment but which are not in the best financial interests of the funds' members.

It is our belief that trustees of defined-benefit schemes are already as a matter of good practice looking at the stewardship activities of their investment managers and we are continuing to assist them with this – we monitor this via our annual Engagement Survey. With regards to defined-contribution schemes, the recently revised Pension Regulator's DC Code makes an explicit reference to stewardship. Additionally, trustees of

defined-contribution schemes regularly offer funds that fit members' ethical preferences such as sharia funds and ethical funds that avoid certain investment categories because members may prefer them. In those cases, the trustees' fiduciary duty extends to ensuring that the fund offered is also in the member's financial interest and its features and benefits are appropriately communicated, but it is the members themself who exercise the discretion to invest in any fund.

We believe that the importance of vetting any and all investments from all perspectives should be emphasised, and that investment managers should be encouraged to be more transparent concerning how funds are being invested and how extra-financial considerations come into play in choosing investments. However, we do not believe that there is any need to further define fiduciary concepts or to introduce additional objectives in order to hurry this process along. Pension fund trustees should concentrate on getting good value for members, protecting and enhancing the real value of their retirement income.

2. Can a trustee's fiduciary duty be delegated to others? Can a fiduciary duty be limited by contract?

We asked the pensions specialist law firm Sackers to look into these questions for us. Their conclusion was that while implementation of an exercise of fiduciary discretion can be delegated, the duty to exercise the discretion in accordance with fiduciary principles probably cannot - a core fiduciary responsibility will continue to reside in the trustee. In practice this will usually translate to trustees retaining an on-going duty of supervision where certain activities are delegated. This is expressly recognised in section 34 of the Pensions Act 1995 which provides that trustees can properly delegate their investment discretions (and will not be liable for the exercise of those discretions so delegated) although the trustees must take reasonable steps to satisfy themselves that the appointed manager has the appropriate knowledge and experience and is carrying out his work competently. Furthermore, a pension scheme's trust deed will typically vest powers in the trustee alone, and so it seems unlikely that the trustee could ever fully extricate itself from a "core" fiduciary duty vested in the trustee by law or in the trust deed.

Similarly, there is nothing in legislation to confirm whether fiduciary duties can be limited by contract. It is clear under case law that where a fiduciary duty arises under contract it can be limited under contract. It is less clear, however, whether a fiduciary duty arising out of equity or the nature of the relationship can be contractually excluded. For example, we do not believe that trustees can contractually limit their fiduciary duties where the trust deed does not limit them. However, where fiduciary duties arise under trust those duties can be limited by the trust deed. For example, under a trust based occupational pension scheme it is standard practice to permit trustees to profit from their scheme membership and is common to see a clause that allows the trustees to manage conflicts of interest.

Investment management agreements between trustees and investment managers commonly contain clauses in which the investment manager defines the relationship as one in which services are provided and such agreements often state that the manager is not acting in a fiduciary capacity. Whether such contractual language would provide protection for the manager in the face of a suit by a beneficiary (who was not a party of the contract and therefore has not agreed to its terms) alleging that a fiduciary relationship existed as a matter of law, and fiduciary duties were breached, is open to question. It should be noted that most investment management agreements contain a clause excluding third party rights, which restrict the ability of a beneficiary to bring a contractual claim against the investment manager under the agreement.

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PART B – the investment chain

3. Can or do others in the investment chain have a fiduciary duty – Employers? Providers? Investment managers? Consultants?

How the presence or absence of such a duty affects (or would affect, if it were imposed) outcomes for members is in practice unclear. Our general view is that fiduciary duties do not extend, and should not be extended, to other parties in the investment chain. However, it may be appropriate to make the duties of care that are owed by investment managers, employers, providers and consultants more explicit – the DWPs work on Quality Standards is helpful - and to put more resource towards enforcement where those duties are not fulfilled.

a. Do or should investment managers owe a fiduciary duty to trustees?

Managers operate within the terms of the fund's Statement of Investment Principles (SIP) and the scope of their responsibilities and liability are set out in the Investment management Agreement (IMA).

Although investment managers have discretion over the investments of trust funds within the confines of the mandate, we do not believe that this relationship gives rise to a fiduciary duty to the trustee any more than it gives rise to a fiduciary relationship with any other investor. Trustees are owed a duty of care and should be sufficiently sophisticated to enter only into contracts that protect their stated interests. We do think, however, that others in the investment chain, including investment managers, should have a responsibility to understand the fiduciary duties of their clients as part of their duty of care.

We do not think that imposition of a fiduciary duty towards trustees would be helpful, as investment managers are not in a position to fully investigate the investment strategies of the trustees, or to evaluate their "best" interests. Moreover, if the investment managers' potential liability expands in relation to the mandate, one consequence is likely to be a narrowing of the mandate so that there can be no question concerning whether wider investment choices should have been considered as a matter of fiduciary duty. This would not be in the interests of pension funds where a looser mandate would allow the manager to take advantage of a wider range of opportunities.

This is not to say that acting in a manner that is manifestly not in the interests of the trustee – or any other client – should be accepted. Whilst there are inherent conflicts of interest at an asset manager, we do not believe that the imposition of a fiduciary duty should be necessary to stop practices such as charging for unnecessary service, churning transactions, or failing to thoroughly vet decisions that have an element of conflict of interest. These sorts of practices already violate the duty of care and fair treatment, and moreover can be more effectively and uniformly overseen by a regulator (which has powers where the duty of care has been violated) than by the courts (which are typically the forum in which fiduciary breach is determined).

b. Do or should investment managers owe a fiduciary duty to members?

Where an investment manager is aware of a beneficiary with whom it has not directly contracted, can there be a fiduciary relationship? We think that the answer could be different depending on whether the member is in a trust-based or contract-based scheme.

Where there is a trustee in place, evaluating the members' interests and formulating and pursuing a broad strategy on their behalf, it makes sense that the manager exercises only a duty of care in line with the terms of its mandate for all of the reasons set out above.

The question becomes a bit murkier in the contract-based space where there may be no one implementing a broad strategy for the member. It is unreasonable to expect members of contract-based schemes to acquire sufficient knowledge and understanding to act in an environment of *caveat emptor*, and members who participate in workplace-based schemes should not be considered unreasonable if they rely on the judgement of the manager and the employer who chose the manager.

That said, the practicality of assigning explicit fiduciary duties to investment managers presents a host of problems. Investment managers will not have sufficient information about the membership to act in a fiduciary capacity – they will not know, for example, whether members are wholly or partially invested in any given fund. They may not know much about the demographics, financial situation or risk appetite of the members. At most, they can be expected to provide an investment that is suitable for pension investment within the boundaries of certain descriptors that have been given to members. Once again, it would seem wiser to limit the investment managers in the contract-based environment (which will always be a defined contribution environment) to a duty of care that relates directly to the description of the fund that has been given to the members.

Of course it could be considered that because ESG risks, where material, are financially relevant to an investment, that if the fund manager was to act in the best interests of its clients then they would be monitoring - and subsequently engaging upon – these extra-financial factors within investee companies in an effort to protect and enhance the risk-adjusted returns to the fund. There should be no reason to mandate or legally require consideration of these factors, in the same way as one would not legally require or mandate a an investment manager to consider inflation risk or currency risk when assessing investment opportunities. As such, assessing the appropriate levels of transparency to clients could be a more appropriate remedy than imposition of extra or more explicit duties; this would enable trustees to more effectively manage their agents.

c. Do or should pension providers owe a fiduciary duty to members?

Providers, typically insurance companies, are regulated by financial services legislation. Although the employer typically chooses the provider of the pension savings vehicle, the enduring contractual relationship is between the provider and the member. At first glance, this would seem to set the scene for a fiduciary relationship between the provider and the member.

However, it is difficult to reconcile a provider's duties to its shareholders with an exclusive focus on the beneficiary, as is required of the classic fiduciary where there is a conflict of interest and there is such a conflict here. It is difficult for example to imagine the duty extending to a requirement that the member's fund be transferred to another provider. Under current law, the provider's ability to switch the member's investment from that for which the member or employer contracted is limited and is governed by laws relating to mis-selling of products rather than duties to members - indeed it may be that mis-selling is the greater danger to members. Meaningful fulfilment of most aspects of fiduciary duty towards the member would require the provider to take on powers that the member contractually retains, which simply does not work from a legal point of view.

On the whole, providers might better be persuaded to act responsibly towards members through evolving duties under FSMA or other statutes imposing a duty of care rather than assigning a fiduciary duty. The particular implications of enrolment in a workplace-based pension scheme could be better addressed by the FCA than is the case currently, where pensions are treated much like other financial "products" that are shorter-term in nature and usually chosen by the member. Another route could be to introduce governance arrangements such as funded member interest groups at the provider level.

d. Do or should employers owe a fiduciary duty to members?

In a trust-based environment, the employer has established and usually funded a board of trustees to look after members' interests and it is with that trust that the fiduciary responsibility lies. In addition, the employer is also a beneficiary or potential beneficiary under the law, whose interests must be considered by the trustees and balanced with those of other beneficiaries. Therefore it does not make sense for the employer to retain a fiduciary role in this context.

However, where the employer has chosen to provide a workplace contract-based scheme, as discussed above, many of the functions taken on by the trustees are diffused or left with the member. The employer is the party executing the initial decisions, and overseeing the results. Although his powers are more restricted than those of a trustee, who is the legal owner of trust assets, the relationship with many of the beneficiaries (at least those members remaining in the employer's employment) is closer than that of the provider or investment manager, and the discretions that are left to the employer may be sufficient to give rise at some places to a fiduciary relationship. For example, the employer must choose the provider and with such choice it may follow that a duty to monitor outcomes for members also arises.

A fiduciary relationship does not appear to be currently recognised in law. Under current law, the employer owes its employees a legal duty of good faith, and must not to act in a way that is likely to destroy or seriously damage the relationship of trust and confidence between employer and employee. However, these are not understood to continue once an employee leaves. Therefore, they may not be fit for purpose where pension provision is concerned.

That said, there are some important practical and policy reasons to hesitate to impose a fiduciary duty here. As noted above, the power to change investments already made resides solely with the member, and changes to member investments could give rise to mis-selling claims (although responsible employers may conduct communication campaigns that allow transfers to be made with only implicit member consent). Information about individual member situations is limited due to data protection legislation. Where the member is no longer an employee, there may be no way for the employer to maintain contact. Therefore, any fiduciary duty that may exist would be limited to those matters as to which the employer has a power to exercise a discretion, and would leave member protection incomplete.

Moreover, in the wake of auto-enrolment legislation we must acknowledge that many employers are not volunteers, and the concept of fiduciary duty rests in part on the notion that the fiduciary has voluntarily entered a relationship of trust and confidence with the beneficiary. Many employers are enrolling employees because the law now requires them to do so and compulsion does not sit well with a fiduciary obligation.

It is worth exploring whether there are some common principles from the current legal duties that can be incorporated into employer duties in relationship to pension arrangements. However, we are sceptical that a

fiduciary duty is appropriate here. Employers, especially smaller employers, should be encouraged to use a large, well governed scheme, a Super Trust, for automatic enrolment. This creates flexibility for governance to sit in different places, such as governance over a selection of funds from different providers. However, where employers make an active choice to establish a contract-based scheme, it would then be appropriate for them to bear a responsibility to establish an effective management committee which can look out for members' interests.

PART C – Solutions

4. If 'fiduciary duties' do not apply, can other duties, such as the duty of care owed by investment managers and providers or the duty of good faith and fair dealing owed by employers be better articulated or adapted for in the pensions context?

There is merit in considering whether the duties of care owed by employers to employees and from providers to employers/members could be articulated more clearly and whether the way in which those duties interact with activities associated with pension provision could be more explicit. It will be important to acknowledge the limitations of each of these relationships and thus to tailor arrangements appropriately. Clear codes of conduct for those involved in pensions provision coupled with a meaningful enforcement regime may yield better results than imposition of fiduciary duties, which after all require the member to sue in order to get the desired result. This merits more discussion.

5. Does the law as it stands do enough to encourage long-term investment strategies? What more can be done?

We do not believe that the presence or absence of a fiduciary duty or the understanding of fiduciary duty by fiduciaries is an impediment to member protection or to long-term investment strategies. Clear articulation of current law in the pensions arena and consistent enforcement of current requirements, such as the requirement that customers be treated fairly, is likely to be more a more effective way to protect members in the contract-based sphere.

If, and understandably so, encouragement of longer-term investment strategies is a goal, then reforms to accounting standards (IAS19) would be a more effective way to combat the causes of some short-termism. Accounting standards currently require that pension deficits be captured at a single point in time, and as a result, unless pension deficits are managed for stability, sponsor financial statements will reflect short-term stock market volatility and interest rates. We think that the current focus on short term deficit management and the related desire to quantify and measure is much more a product of accounting rules than of failures of understanding of fiduciary duty.

More generally, in the new DC environment, we believe that large scale, good quality trust-based pension schemes – super trusts - would secure better outcomes for savers. These Super Trusts can benefit from economies of scale and leverage those savings to benefit members. Additionally, they would likely be better equipped with greater internal investment expertise and resources and thus have the confidence and knowledge, to challenge fund managers where appropriate.