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Securing the future of pensions

Fiduciary Duties of Investment Intermediaries – a review by the Law Commission

An NAPF Response

January 2014

Executive summary

- The fiduciary duties of trustees of pension funds are well 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.

- When examining the members' best interests, it is important to keep in mind that these interests are not general interests, but rather relate to the purpose for which the trust was created. Inasmuch as the purpose of a pensions trust is to provide income in retirement, the members' interests in the pensions context is 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' longer-term financial interests, and there is sufficient scope under current law for trustees to take a longer term view of their investment needs.

- The assets pension funds own and oversee can play an important role in determining the society members inhabit in the future and thus, the real value of their retirement income. The current law is appropriately permissive to enable trustees to incorporate environmental, social and governance (ESG) factors within their investments where these are financially material. While it would be inappropriate and unhelpful to *require* consideration of ESG factors for each investment decision, it is appropriate for trustees to take such factors into account when devising an investment strategy - as they do with other risk factors - and to instruct, and hold accountable, those to whom they delegate day to day investment decisions.

- Stewardship, including engagement with investee companies and the informed use of votes, while not a legal duty, is a responsibility of owners and an *implicit* fiduciary duty of pension fund trustees and their investment managers. The NAPF supports the view of the Financial Reporting Council (FRC) as set out within the UK Stewardship Code which states that institutional investors may delegate activities associated with stewardship but retain the ultimate responsibility for the way in which those activities are undertaken.

- In the case of most pension funds the consideration of ESG factors and the activities associated with stewardship are delegated to their investment managers who owe a duty of care to their clients to adequately consider issues and undertake such actions as appropriate to the investment strategy.

- We are unconvinced that it would be beneficial to seek to provide more clarity through statute, for example by imposing an explicit duty to consider specified factors when devising an investment strategy. Instead, the Law Commission may wish to consider producing an open letter that could be sent to trustees and investment intermediaries summarising the key conclusions. This exercise would benefit trustees by making it clearer that they can consider wider factors such as ESG issues when making investment decisions and that fulfilment of stewardship responsibilities is compatible, indeed aligned, with a trustee's fiduciary duty. Importantly, such a letter could help to distinguish between factors and approaches that are at heart financial in nature and those that are ethically driven.

- There is widespread agreement that a governance vacuum in contract-based pension arrangements can lead to suboptimal outcomes for members. We do not feel however, that the assignment of a fiduciary duty to providers or others who have not traditionally been held to fiduciary standards would improve the situation. We instead believe that 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. We believe that good governance of pension arrangements is a logical extension of the employer's current legal duty of good faith. The NAPF recommends that employers, as the ultimate decision makers in appointing workplace pension schemes, are given the obligation to put in place a governance arrangement to support the interests of pension savers.
- We are not convinced that Independent Governance Committees at the provider level, as recommended by the OFT, will be as well placed as scheme level governance – e.g. trustee bodies - to support pension savers. No other party can match the powers that trustees have as owners of the assets.
- If Independent Governance Committees are formed, we believe that they should be constituted primarily to act on behalf of employers, who as the purchasers are the actors that should have responsibility for bringing in pension arrangements that offer value for money and also have the most influence over the provider (regardless of the fact that the employee holds the individual contract). The employers will be best placed to see that the providers deliver what is promised, and, on the whole, they will have more resources to devote to overseeing the investment and service arrangements. Then the chain of accountability from saver through to their investment managers would be much clearer and the relevant duties, of each party would be better aligned.

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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.

Consultation questions

Pension trustees' duties to invest in the "best interests" of others - current law

Question 1 Do consultees agree that Chapter 10 represents a correct statement of the current law? (14.6)

Trustees of pension funds understand that they are required to prioritise the interests of the beneficiaries of the pension fund above all else, avoiding or managing 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.

The interpretation of the law as set out within the consultation document rightly suggests that the law as currently understood is sufficiently permissive to enable trustees to use their judgement and discretion appropriately. This flexibility extends to consideration of environmental, social and governance (ESG) factors and to fulfilment of their stewardship responsibilities as set out within the UK Stewardship Code. Both consideration of appropriate ESG factors and the undertaking of stewardship activities can be deemed relevant to the financial performance of the fund and the value of the benefits received at retirement - as such neither can be deemed to be outside the scope of a pension fund trustee's fiduciary duty.

As articulated within the Stewardship Code, effective stewardship benefits companies, investors and the economy as a whole. In addition, robust independent research makes it increasingly clear that active stewardship and integration of ESG factors within investment decisions may lead to improved risk-adjusted performance; it certainly shouldn't lead to detrimental returns and will likely provide protection against potential value destruction. In other words, we believe that it is appropriate to consider these wider factors in the same way that one would expect other risk factors to be considered when making investment decisions. For this reason the NAPF deliberately termed these factors "extra-financial factors" in its Responsible Investment Guide published in May 2013.

In November 2013 the NAPF published its ninth annual survey of pension funds' engagement with investee companies[1]. Respondents to the survey were nearly unanimous (96%) in their view that institutional investors, including pension funds, do have stewardship responsibilities which include both engaging with companies and voting shares. In addition, 82% of respondents agreed that ESG factors can have a material impact on their fund's investments in the long-term - only 6% disagreed.

Given the above, the NAPF is of the view that:

- ESG factors and effective stewardship activities can affect long term investment performance.

[1] NAPF Engagement Survey, 2013, http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/0354_NAPF_engagement_survey_2013.aspx

- The assets pension funds own and oversee can play an important role in determining the society members inhabit in the future and thus the real value of their retirement income.

- Monitoring and engaging with investee companies along with the informed use of votes, while not a legal duty, is a responsibility of owners and an implicit fiduciary duty of pension fund trustees and investment managers to whom they commonly delegate this function.

- Which ESG factors are material will vary across sectors and geographies; however, their materiality means that at some point in the future, they will manifest as a financial impact. The successful integration of such factors within decisions by investors can therefore moderate against investment risk and potentially improve risk-adjusted returns.

The primary motivation for assessing factors for inclusion within an investment strategy is to manage those risks that are important drivers of returns and to minimise those risks that are not return-related. Given the evidence that ESG factors will, sooner or later, affect both the bottom line and the value of the benefits in retirement, there is an increasing appreciation that the consideration of ESG issues should be viewed as financial in nature. Moreover, as use of passive-index funds grows, it is the importance of the health of the market as a whole which is ever more relevant and important; thus the need to monitor and engage on ESG risks is just as appropriate to both alpha and beta investors.

The current law is clear that pension trustees *can* take account of ESG factors within their investment decisions. We would suggest that trustees *should consider* how wider extra-financial factors are appropriate to their investment strategy, and where consideration of such factors is appropriate trustees should ensure they are being taken into account by those to whom they delegate such activities.

At present, in order to comply with the Occupational Pension Schemes (Investment) Regulations 2005, pension fund trustees must prepare a Statement of Investment Principles stating; "the extent, if at all, to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments" and explain their policies in respect of the exercise of the rights (including voting rights) attaching to investments. As drafted, these regulations may encourage the conflation of "ethical" considerations and financially material environmental, social and governance considerations. We think there is merit therefore in considering amending the SIP requirements to focus more on those activities in relation to ESG factors and stewardship, separating these activities from the discussion of ethical considerations. Ethical considerations will be appropriate much less frequently and are less integral to the decision-making process than ESG and stewardship. Additionally, as at present, trustees should set out how they would ensure that where the responsibility for such activities is delegated to investment managers or third parties (as is usual practice), these issues are undertaken appropriately.

We believe that the importance of vetting investments from all relevant perspectives should be emphasised, and that investment managers should be encouraged to be more transparent concerning how funds are being invested and how ESG considerations come into play. 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.

Question 2 Do consultees agree that the law reflects an appropriate understanding of beneficiaries' best interests? (14.11)

Yes, this area of law has been subject to a significant amount of examination over the years as is set out within the consultation document. At times the conclusions of certain cases are not accurately stated, either due to oversimplification, misunderstandings or at times wilful misrepresentation. However, we do not think this amounts to a problem with the law itself. It is widely understood and agreed that the members' interests in the pension's context will be primarily, but not solely, financial.

Question 3 Do consultees think that the law is sufficiently certain? (14.15)

The current law is flexible, allowing trustees the ability to utilise their judgement and discretion to invest as they consider appropriate to meeting their objectives, responding to opportunities and challenges as they arise, and allowing for adjustment over time as notions of best practice change.

Trust law is based on equitable principles which by their nature are fluid and based on a sense of what is right under the circumstances. This approach is the right approach for this subject, and what it lacks in certainty it makes up for in adaptability.

Question 4 Should the Occupational Pension Scheme (Investment) Regulations 2005 be extended to all trust-based pension schemes? (14.15)

Many small schemes could struggle to cope with an extension of the Investment Regulations, because they have already invested in less liquid investments than they would have had to invest in if they were otherwise covered. These schemes would be forced to take a shorter term view than they have taken to date, and could be required to divest at an inopportune moment. The Investment Regulations themselves do not necessarily lead to a longer-term outlook, as they militate against derivative instruments and investments that are not listed on exchanges.

Such a change may simply push small schemes towards utilising index funds. While such funds are not in themselves an issue, it should be considered whether such a response is desirable.

Question 5 Are there any specific areas where the law would benefit from statutory clarification? (14.15)

We are unconvinced that it would be beneficial to seek to provide more clarity through statute or by imposing a more explicit duty to consider specific factors when devising an investment strategy. Such an approach would be very difficult to appropriately draft and would struggle to keep pace with emerging best practice and investment trends. Indeed, such an endeavour could result in a less permissive investment environment.

There are a number of considerations that go into any investment instruction, attempting to prescribe these factors would only 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 in which politicians would like to see more investment but the market has priced unappealingly; any investment decisions need to be in the best financial interests of the funds' members.

That said, 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. This Law Commission review in itself should go a long way to debunking any myths or misinterpretations that exist.

The Law Commission may wish to consider producing an open letter which could be sent to trustees and investment intermediaries summarising its key conclusions. This exercise may be most beneficial in terms of reaffirming that trustees can consider wider factors than short-term fund performance, including ESG issues, and that fulfilment of stewardship responsibilities is compatible, indeed arguably aligned, with a trustee's fiduciary duty. Similar exercises by the FSA have proved helpful, for example the open letter following the Walker Review in 2009 clarifying the consistency of shareholder engagement with market abuse regulations.

Question 6 Do consultees agree that the law permits a sufficient diversity of strategies? (14.21)

Yes we believe that the current law does allow a sufficient diversity of strategies. The issue under debate via the examples cited within the consultation paper is not the law itself but its overly prudent interpretation by some parties in some circumstances. The law, as already discussed above, is sufficiently flexible to enable the trustees to undertake investment strategies that they deem are appropriate for their objectives, so long as these strategies are consistent with their powers under the trust deed.

It is important to remember in these debates that investments are generally managed by fund managers. As such human behaviour will remain a factor which it is not possible to regulate out.

More generally, we believe that large scale, good quality trust-based pension schemes – super trusts - would secure better outcomes for savers. These larger funds would likely be better equipped with greater internal investment expertise and resources and be able to benefit from the economies of scale and leverage; as such funds would likely have the confidence and knowledge, to confidently embark on different investment approaches and to challenge fund managers where appropriate.

It has also been suggested that the requirement that investments must be "predominately" those "admitted to trading on regulated markets" can cause larger or more sophisticated schemes some issues because these schemes may have more substantial investments in assets such as real-estate, infrastructure or private-equity holdings. Such investments may be the sort of longer-term assets deemed desirable and "long-term" but are usually not "admitted to trading on regulated markets". There is therefore merit in a debate about the current appropriateness of this requirement, although we realise that inasmuch as it is driven in part by European legislation, removal of the requirement could be complicated.

Question 7 Do consultees agree that the main pressures towards short-termism are not caused by the duty to invest in beneficiaries' best interests? (14.24)

Yes we strongly agree. Much of the short-termism in investment is due to factors other than the duty to invest in beneficiaries' best interests.

Issues such as lack of scale, a desire to minimise the effect of pension deficits on company balance sheets and/or cash funding requirements; 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 are more influential.

If 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, employer 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.

We also welcome the work being sponsored by the Department for Business to look at the appropriateness of the current metrics used for evaluating the performance of fund managers.

Question 8 Do consultees agree that the law is right to allow trustees to consider ethical issues only in limited circumstances? (14.28)

Yes. We agree with the efforts to distinguish purely ethical concerns from those such as ESG factors that are at heart financial in nature.

We 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 interests of *all* members and could lead to conflicts of interest between the trustees’ ethical preferences, or those of a segment of the members, and the best long term financial interests of all the beneficiaries.

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 whole 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.

Many ethical or moral issues have a financial dimension, for example many ethical investors have a strong view on climate change. In these circumstances there is nothing in trust law preventing trustees including these factors within their investment approaches as a material ESG factor, indeed it can be argued that trustees should consider doing so. However, in those circumstances where an ethical factor would likely have a detrimental financial impact on the fund then we agree with the view that consideration of these factors would lie outside the duties of the trustees.

The duty of trustees of defined-contribution schemes is to offer a suitable range of funds appropriate to their scheme’s membership. As such many trustees will choose to include as part of the fund range, 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 funds offered are also in the member’s financial interest and their features and benefits are appropriately communicated, but it is the members themselves who exercise the discretion to invest in that fund.

Question 9 Does the law encourage excessive diversification? (14.32)

See answer to Question 10 below.

Question 10 Does the law encourage trustees to achieve the right balance of risk and return? (14.32)

The current law requires that assets should be properly diversified to avoid 'excessive' reliance on any particular asset, issuer or group of undertakings. The objective of the current law is to provide the right balance of risk and return.

We disagree with the occasional assertion that increasingly diversified portfolios have led to ownerless corporations. While this is of course a factor, the bigger influence is the increasingly global nature of capital. The current use of collective investment schemes or pooled vehicles can provide diversification while still providing sufficient (if not increased) leverage and power to the pooled vehicle to act as a responsible steward of the assets under management through engagement with investee companies.

It is commonly accepted that in some cases the pendulum towards diversification has perhaps swung too far towards diversification for diversification sake with ever diminishing benefits accrued from the efforts made. That said, amending the regulations is not required or desirable if one wishes to move the pendulum back. Instead, reviews such as the Kay Review, are encouraging investors to give this issue renewed thought and the market is responding with new products and approaches – e.g. diversified growth funds.

It is important to remember that the law is applicable to funds which range from tens of billions in assets under management to a few million and below. Smaller schemes may not be in a position to diversify efficiently, and may not have the same access to resources and advice as larger schemes. We think that a move to larger-scale funds should make any problems for the smaller schemes less significant.

Question 11 Are there any systemic areas of trustees' investment strategies which pose undue risks? (14.32)

Counterparty risk resulting from greater exposure to long dated swaps is certainly a key concern for a number of our members. As liability matching strategies grow in popularity, consideration of counterparty risk is a major priority. In addition, a wave of new regulation is increasing both collateral and in turn liquidity risks.

Question 12 Overall, do consultees think that the legal obligations on trustees are conducive to investment strategies in the best interests of the ultimate beneficiaries? (14.33)

Inasmuch as the primary legal obligation is to invest in the best interests of the ultimate beneficiaries, yes we think that the legal framework is set up to deliver exactly that. As already described above we believe that it is other considerations and requirements that may sometimes interfere with the achievement of this objective.

Question 13 If not, what specifically needs to be changed? (14.33)

Question 14 Do consultees agree that the duties on contract-based pension providers to act in the interests of scheme members should be clarified and strengthened? (14.42)

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.

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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. Moreover, under current law, meaningful fulfilment of most aspects of fiduciary duty towards the member would require the provider to take on powers that the member contractually retains; this simply does not work from a legal point of view.

As such we suggest that further thought be given to how long-term products like pensions savings vehicles are governed and regulated. We understand that the FCA is putting more resource into issues arising from auto-enrolment and welcome this. Currently group personal pensions are treated much like other financial "products" that are shorter-term in nature and chosen by the ultimate customer; 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. Pensions have been allowed to become opaque and the charging structure has not been sensitive to market forces. The ever-changing tax code has also not helped.

As an initial matter, more emphasis should be put on the provider's responsibility to be as transparent as possible about those things that matter most to the consumer - e.g. charges - and to communicate clearly and effectively.

However, this is only a first step. One of the current problems is that the changes that may make the biggest difference over time to the consumer are not changes to the pension contract - that stays the same. Instead, it is changes to the wider economic environment, the law, and the consumer's personal circumstances that have the most impact. These factors may mean that a contract entered into 20 years previous no longer remains suitable, or even fit for purpose. However, currently there are many laws discouraging a provider from effectively "selling" a new product, or even a new investment strategy, to the consumer, and little to encourage that provider to approach the consumer with a deal that would be better suit them. More thought therefore needs to be given to this situation, because even with the best will in the world, the provider may have limited ability to do better for the consumer under the present structure.

In the end however, if there is a desire to give providers a duty to look at the best interests of members, there need to be actions that the provider can take. At present, the provider is often constrained by contract from undertaking remedies available to trustees.

Question 15 Should specific duties be placed on pension providers to review the suitability of investment strategies over time? If so, how often should these reviews take place? (14.42)

Specific duties on providers to review the suitability of investment strategies over time would likely be helpful. However, there are limitations to their ability to subsequently take any actions as outlined above – providers will need to be able to switch investment strategies.

Such a change would involve a number of complications. An investment strategy that might be better for some won't necessarily be better for all, and changing the strategy without permission could lead to legal action. A debate would be needed as to where the line is drawn between consumer choice and paternalism. Pensions contracts could be written to anticipate a changing strategy, but most now in place would not allow such changes without risk to the provider.

Question 16 Should members of Independent Governance Committees be subject to explicit legal duties to act in the interests of scheme members? (14.42)

As the OFT rightly recognised in its recent market study, employers are increasingly opting for contract-based DC schemes where pension providers are responsible for the delivery of pension provision for pension savers; this environment means there is a significant governance gap which needs rectifying. However, we believe that Independent Governance Committees (IGCs) as recommended by the OFT will not be as well placed as trustee bodies to support pension savers, as they will not own the assets or be involved in deciding who will administer or invest them. Therefore, some thought needs to be given to what their powers should and could be and on whose behalf they will act.

Where an employer has chosen to provide a workplace contract-based scheme many of the functions taken on by trustees in an occupational scheme are left with the member. However, the employer is the party executing the initial decisions regarding the pension arrangements. We believe that a duty to monitor outcomes follows from this exercise of discretion. In addition, at least in respect of active employees, the employer has 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. All of this militates for some duties of the employer running to employees in respect of the pension arrangement chosen, although these duties fall short of a fiduciary duty, and may not extend to the employee once the employee has left service.

The NAPF therefore recommends that employers, as the ultimate decision makers in appointing workplace pension schemes, be obliged to put in place a governance arrangement to support the interests of pension savers. An employer could use its own management committee under a contract-based arrangement, or could delegate this function to the IGC, in which employers would participate.

To return to the question, we wonder how IGC's would have sufficient powers to act in the members' interests, in which case the duty to *act* in the member's interests would be difficult to fulfil. We therefore envisage IGCs more appropriately acting as oversight panels, examining the contents of the contracts for fairness, keeping track of costs and fees, and holding investment policies to scrutiny.

Given our view, as set out above, that employers have a duty to put in place appropriate arrangements, we suggest that IGCs would likely have more influence and be more clearly aligned with the interests of employers, and consequently members, if they were constituted primarily by and of employers – membership could also include employee (e.g. Union) representation as well as independent members, as per current trustee boards – but their duty would be to report to employers regarding how well their employees' interests are being served. This approach in our view would be most consistent with the current law and market structure. In turn employers would within their duty to their employees be required to act if the provider did not respond appropriately to concerns raised by the IGC. This would thus create effective market accountability as well as a clearer chain of accountability from provider through to the underlying saver

Question 17 Should pension providers be obliged to indemnify members of Independent Governance Committees for liabilities incurred in the course of their duties? (14.42)

Yes, in order to attract and empower individuals to join and actively participate as members of IGCs an indemnity would appear to be a pre-requisite requirement.

Question 18 Do consultees agree that the general law of fiduciary duties should not be reformed by statute? (14.61)

Yes. As explained in answer to other questions, we are unconvinced of the need to reform or clarify fiduciary duties by statute or to attempt to distribute fiduciary duties to actors in the investment chain who have not clearly accepted that role. We think that such a process would be unnecessarily lengthy with little value offered.

The undertaking to act for a beneficiary in trust is very different from a contractual duty or a general duty to deal fairly and without fraudulent intent. We think that introduction of the more onerous duty of trust is inappropriate where the relationship is primarily commercial and an attempt to impose it in such relationships would only dilute its force.

That said, the misconceptions outlined within the Kay report should be addressed. In particular we particularly welcome the discussion of where fiduciary duty now sits and what it means, particularly where trustees are considering wider factors. We believe that the Law Commission's findings, when published, will serve that purpose well. In addition, clearer standards of conduct applicable to employers and providers will assuage many concerns about the duties of those parties within the investment chain.

Question 19 Should rights to sue for breach of statutory duty under section 138D of the Financial Markets and Services Act 2000 be extended? (14.67)

We do not believe that the case has been made for extending the right to sue for breach of statutory duty under FSMA. Where there has been bad behaviour, other rights of action (including under contract) will probably exist and a breach of regulatory rules will be powerful evidence in those actions. As the consultation paper recognises there will be a reluctance to impose liability where the plaintiff is a sophisticated investor and the situation is one of technical breach.

Question 20 Is there a need to review the regulation of investment consultants? (14.71)

Again, we are not sure that a case has been made for more regulation. Increasing regulation in this area is unlikely to be helpful unless we reach a better understanding of what the failings of investment consultants are supposed to be. At present we are not aware that pension scheme trustees rely to any substantial extent on "generic" advice and indeed the laws and guidance in place discourage such reliance. The NAPF has previously issued a Best Practice Principles for Investment Consultants and a Balanced Scorecard for Investment Consultants which can be used to evaluate consultants; we are currently in the process of working on an update of the Investment Consultants assessment

Currently most investment advisers giving advice to pension schemes are already authorised persons. A conflict of interest – such as a close relationship with a manager or an in-house choice - would seem to be a different problem, but one that should be managed through existing laws.

Question 21 Is there a need to review the law of intermediated shareholdings? (14.74)

It is usual practice for institutional investors to hold bonds, shares and other investment securities indirectly through financial intermediaries; the investor is commonly understood to be the "beneficial owner" as opposed to the registered owner of a security. This intermediated relationship has many practical and

administrative benefits; however, it also creates counter-party risk for the underlying investor and also presents potential legal barriers to their ability to exercise their shareholder rights.

In the UK it is trust law which oversees such custody arrangements; enabling the investor, as beneficiary, to retain a proprietary interest in the securities being held on its behalf by the intermediary. Trust law imposes a number of fiduciary duties upon the intermediary to its account holders; these include the safeguarding of assets and account for any profits arising from the securities held on trust. This trust law applies whether assets are held within a pooled or segregated account.

The law for intermediated securities, from an investor's perspective, needs to protect the interests of the beneficial owner from the claims of creditors of the intermediary and it needs to provide them with the ability to exercise their rights and the reassurance that they will receive the economic benefits derived from 'owning' the security. The trust law approach taken within the UK generally achieves these requirements. Given the global nature of capital markets however, with a high volume of cross-border settlements from an increasingly diverse investment universe, a consistent approach to such matters is always preferable in order that investors are reassured that they have at least a minimum level of rights wherever they invest.

In relation to the exercising of shareholder rights, the UK has generally adopted a shareholder-orientated approach to company law – e.g. company directors owe a duty to the shareholders as a whole and Company Law has concentrated on making it easier for intermediaries to vote on behalf of their indirect investors. We support this approach although the length of the chain does present difficulties and past research has demonstrated that in the UK votes are frequently lost within this chain of intermediaries.

A number of initiatives such as the UK's 2010 Stewardship Code, the EU's 2011 UCITS (Undertakings for Collective Investment in Transferable Securities) Directive IV and 2007 Shareholder Rights Directive – finally fully implemented in all of the EU Member States in 2012 – have all gone some way towards incentivising the exercising of shareholder rights and reducing the barriers to cross-border voting by removing obstructive local practices.

That said, improvements can still be made,. For example, the Shareholder Rights Directive has not been implemented in a consistent manner across Europe. We also think it would be helpful if the Law Commission expressed a view as to whether there are, as cited by some, legal barriers preventing the directing of voting by pension funds within pooled accounts

Question 22 Should the FCA review the regulation of stock lending by custodians? (14.75)

We understand that a review of stock lending regulation is already a welcome part of the FCA's work plan.

The number of pension funds using stock lending has reduced post financial crisis Historically, part of the income generated from stock lending was retained by the asset management firm to pay for the administration costs of stock lending; many asset managers, in order to reduce their counter-party risks, have now outsourced their stock lending activities to specialist providers. Where the activity is now outsourced a smaller proportion of any generated income returns back to the client, while the underlying risks remain. While we agree that stock lending by custodians, and any resulting income, should be reported by the custodians to the underlying owners of the shares, we do not believe on current evidence that there a need to further regulate stock lending. Rather this is a matter that would be better resolved by the market.

There are undoubtedly some advantages to the liquidity provided to the market by stock lending, however, there are also risks and forfeiture of certain rights. So long as the risks are understood and the profits distributed to the informed satisfaction of the parties concerned we do not think the case has been made for regulatory action.