Response to Fiduciary Duty consultation
January 2014

Local Authority Pension Fund Forum

LAPFF Response to Law Commission Consultation on Fiduciary Duty

The Local Authority Pension Fund Forum was set up in 1991 and is a voluntary association of 58 local authority pension funds based in the UK with combined assets of approximately £120 billion. It exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote high standards of corporate governance and corporate responsibility amongst the companies in which they invest. The Forum has taken the opportunity below to provide our view on those issues which we consider relevant to our activities.

LAPFF Responses to the Consultation Questions

CHAPTER 14: CONCLUSIONS AND QUESTIONS

14.1 In this chapter we summarise the conclusions we have reached and ask consultees for their views.

14.2 Under our terms of reference we are asked whether fiduciary duties, as established in law or as applied in practice, are conducive to investment strategies that are in the best interests of the ultimate beneficiary. We address this question in four parts:

(1) In Chapter 10 we set out the legal duties placed on pension trustees to act in the best interests of beneficiaries. Our tentative view is that, as established in law, these duties are satisfactory. We ask consultees if they agree.

(2) In Chapter 12 we concluded that the fiduciary-type duties placed on the providers of workplace contract-based pensions are unduly uncertain. We note recent initiatives to address this issue and ask for views.

(3) In Chapter 13 we summarised problems with the way that fiduciary duties apply in practice in workplace defined contribution (DC) pension schemes. We understand that the Department for Work and Pensions (DWP) are carrying out a major programme of work to consider these issues, and urge consultees to engage in this process.

(4) As regards other intermediaries in the investment chain, the law is extremely flexible but also uncertain. As we noted in Chapters 11 and 12, the courts are heavily influenced by the terms of the contract and by the regulatory regime. We think that any statutory reform of the law of fiduciary duties would result in new uncertainties and could have unintended consequences. We ask if there should be stronger rights to sue for breach of Financial Conduct Authority (FCA) rules and whether the rules need to be strengthened in some areas.

PENSION TRUSTEES' DUTIES TO ACT IN THE BEST INTERESTS OF BENEFICIARIES

14.3 In Chapter 10 we consider the duties on pension trustees when devising an investment strategy in the best interests of the ultimate beneficiaries. We were asked how far fiduciaries may, or must, consider:

(1) factors relevant to long-term investment performance which might not have an immediate financial impact, including questions of sustainability or environmental and social impact;
(2) interests beyond the maximisation of financial return; and
(3) generally prevailing ethical standards, and/or the ethical views of their beneficiaries, even where this may not be in the immediate financial interest of those beneficiaries.

Conclusions on the current law

14.4 The primary duty is that trustees must use their powers for the purpose for which they are given. In the case of a pension scheme, investment powers are granted to trustees so that they can earn returns to provide a pension. The pension legislation requires that investment powers are be exercised "to ensure the security, quality, liquidity and profitability of the portfolio as a whole",
(1) without "excessive reliance on any particular asset, issuer or group of undertakings".
(2) The trust instrument may, however, require the trustees to do or refrain from particular things.

14.5 Within these broad parameters, trustees are given considerable discretion, so long as trustees reach their decision in the right way. In particular pension trustees must not "fetter their discretion" by, for example, applying a pre-existing moral or political judgment;
(1) must consider the relevant circumstances; and
(2) must obtain proper advice.

14.6 Stakeholders raised five possible factors which trustees may wish to take account of in making investment decisions. Our conclusions are set out below.

(1) Wider factors relevant to long-term investment performance may be taken into account where they would further the purpose of the power of investment. This includes environmental, social and governance factors relevant to financial returns. Trustees should consider, in general terms, whether they will take account of such factors. However, they are free not to use an approach based on these factors if they consider that another strategy would better serve the interests of their beneficiaries.

(2) Wider systemic considerations (or "macroeconomic factors") may be taken into account. The anticipated benefits of an investment decision based on such factors must, however, outweigh the likely costs. Again, trustees should consider, in general terms, whether to take account of such factors, but remain free to use a different approach if this would better serve their beneficiaries.

(3) "Quality of life factors" (that is, factors relating to beneficiaries' quality of life now and in the future) may only be taken into account when choosing between two equally beneficial investments. They may not be taken into account when this would result in a lower return.

(4) General ethical issues, unrelated to risks, returns or the interests of beneficiaries, may only be taken into account in limited circumstances. They may be used in a defined benefit (DB) pension fund set up by a religious group, other charity or political organisation. Where DC schemes allow individual members a choice of investment strategies, ethical issues can be taken into account with the members' consent. In other cases they should only be used where trustees have good reason to think that scheme members share the moral viewpoint and where they anticipate that the decision will not result in lower returns to the fund.

(5) Trustees may consider the views of their beneficiaries when making investment decisions, but there is no need for them to do so. Trustees must make the ultimate decision.

Q1: Do consultees agree that this is a correct statement of the current law?

Comment: The wide-ranging and in-depth review of fiduciary responsibilities fairly represents the current legal obligations and responsibilities of trustees in trust based pension schemes. The Commission will note that the pension schemes operating with the local government sector are governed separately under the Superannuation Act 1972 and subsequent local government pension scheme regulations and therefore virtually none of the analysis in the report's discussion of the current legal framework applies to LGPS schemes.

However the Forum believes that the analysis presents an accurate portrait of the state of fiduciary responsibilities and should in our view be seen as a valuable assessment by LGPS schemes.

Evaluating the law

14.7 Our terms of reference ask us to evaluate the current law against certain criteria. In particular, we have been asked to consider whether the duties:

(1) reflect an appropriate understanding of the scope of beneficiaries' best interests;
(2) give sufficient certainty to market participants;
(3) permit sufficient diversity of strategy;
(4) encourage long-term investment strategies;
(5) allow fiduciaries to invest in line with generally prevailing ethical standards, even where this may not be in the immediate financial interest of beneficiaries; and
(6) require a sufficient balance of risk and benefit.

14.8 We consider each of these issues below.

An appropriate understanding of beneficiaries' best interests?

14.9 We think the law is right to focus on the purpose for which trustees have been given their investment powers. Pension trustees should focus on providing pensions. As we say in Chapter 10, this is not an easy task. For some DC schemes, with low contributions and low returns, the chances of providing employees with adequate incomes in old age may be low. Without a sustained focus on the objective, the chances of success reduce further.

14.10 Pension trustees may come under outside pressure to use their investment powers to further other objectives. In Chapter 10 we mentioned potential government pressure to invest in infrastructure. As one commentator put it, schemes may be regarded as "the magic porridge pot" out of which the money for roads and railways can be found. External pressure groups may also campaign for pension trustees to use their investment powers to combat a wide range of social ills, from tax avoidance to smoking. We think it may be helpful for trustees to be able to quote the law of fiduciary duties to resist pressures to act in ways which would reduce the benefits available to members.

14.11 Our provisional conclusion is that the law reflects an appropriate understanding of beneficiaries' best interests. We ask if consultees agree.

Q2: Do consultees agree that the law reflects an appropriate understanding of beneficiaries' best interests?

Comment: The Forum notes the understanding shown by the Commission in terms of responding to the need to clearly state what constitutes 'best interests', and in particular the need to reflect appropriate market knowledge of investment opportunities, investment time horizons and balancing short term with long term perspectives when considering the practical implementation of those interests.

It also notes the important distinction between stock based assessments and portfolio based assessments of interests.

Sufficient certainty?

14.12 The law is flexible and allows trustees wide discretion to invest as they see fit. We see advantages to this flexibility, as it allows trustees to respond to new challenges over time. Our tentative view is that it is worth preserving this flexibility, even if the result is some uncertainty.

14.13 The main substance of how pension trustees should exercise their powers is set out in the Occupational Pension Scheme (Investment) Regulations 2005.5 As we noted in Chapter 7, these do not apply to schemes with fewer than 100 active, deferred or pension members. We ask if the Regulations should be extended to all schemes.

14.14 In their paper on Australian pensions in Appendix C, Clayton Utz describe how fiduciary duties are set out in statutory "covenants" under section 52 of the Superannuation Industry (Supervision) Act 1993. These have recently been amended, clarified and expanded. The authors comment that many of the reforms simply made explicit matters which were previously implicit:

For example, it has probably never been appropriate for a superannuation trustee to fail to have regard to the availability of accurate valuation information when selecting investments, to ignore the tax consequences of investment decisions or to fail to understand, monitor and manage the fees and costs incurred in the investment of the fund's assets. Explicit reference to these and other matters in the amended section 52 covenants is intended to address perceived shortcomings in investment behaviour by participants in the superannuation industry.

14.15 We are interested in whether consultees think that there are specific issues in the UK which would benefit from similar types of statutory clarification.

Q3: Do consultees think that the law is sufficiently certain?

Comment: Notwithstanding our remarks on the distinctions between trust based schemes and the LGPS legal framework above, as the Forum sees this issue, the challenge is more to do with how far there exists a 'culture of refusal', with regard to many of the factors identified in the Commission review of matters (cf Chapter 10). Whilst the presentation in Chapter 10 takes a reasonable view of how trustees can explore integrating a range of additional factors that they genuinely believe should be taken into account in formulating and implementing investment strategy, it is common amongst the various advisory influences on trustees that they are almost always advised *not* to take these factors into account. In this regard the Forum believes that more specific clarification of how and to what extent trustees may reasonably explore such investment options should be considered. Perhaps this clarification can proceed through amendments to the Pensions Act investment regulations and the associated OPS (Investment) Regulations in the first instance.

The Forum however is not yet convinced that trustees are under an obligation to take into account the various matters identified in Chapter 10, and that the Commission is correct to state that "*10.65 In 2005, the Freshfields Report suggested that pension trustees should at least consider whether to take wider investment factors into account, even if they then reject this approach:*

Even where ESG considerations are ultimately rejected as having negligible weight (because they have little effect on the relative value of an investment, for example), we think they should form part of the basket of considerations to which a decision-maker has regard.[88]

10.66 We think that this is a sensible conclusion. Even if the duty of adequate consideration does not require this, trustees are also under a duty of care. As part of this duty, we think that trustees should consider, in general terms, whether their policy will be to take account of ESG factors in their decision-making, bearing in mind the resources available to them. The law, however, allows trustees discretion not to take an ESG approach if after due consideration they consider that another strategy would better serve the interests of their beneficiaries."

In addition the Commission note that:

"10.54 As we have explained, the requirement for a trustee to act "in the best interests of the beneficiary" refers to a bundle of duties connected to the exercise of a power and duties of care. The core duty is the duty to exercise a power for the purpose for which it was intended. For an occupational pension set up under trust, investment powers are conferred for the purpose of generating risk-adjusted financial returns. In each case it is necessary to ask “why should we consider this factor?” and the answer must be “because it is authorised by and furthers the purpose for which the power was granted”. Trustees should also be careful that the connection between the investment factor being considered and the furthering of the power’s purpose is not “too remote and insubstantial”. The policy in the SIP on the extent to which ESG factors can be considered should be consistent with this obligation.

10.55 Given the evidence that ESG factors can lead to better returns in the long run, the answer is clearly that pension trustees *may* use wider factors. There can be no objection to using ESG factors as a way of increasing long-term performance.

10.56 We agree with previous advice given on this issue. For example, we endorse the advice DLA Piper gave to the Universities Superannuation Scheme (USS):

> “Where any ethical, social, environmental, corporate governance issue can be regarded as having a current or potential impact on actual or contemplated investment, whether from the point of view of the return to be expected of that investment, its liquidity and/or its underlying capital value, it is in my view wholly consistent with the duties of the Trustee Company referred to above to take those considerations into account.”

Q4: Should the Occupational Pension Scheme (Investment) Regulations 2005 be extended to all trust-based pension schemes?

No Comment

Q5: Are there any specific areas which would benefit from statutory clarification?

The Commission notes the available case law on the extent to which trustees are required – as part of their fiduciary duty – to have regard to responsibilities of ‘stewardship’ in managing their investments. The Forum believes that this is one of the areas for which greater clarification and a measure of incorporation into duties of care, to which further consideration might be given, following this consultation.

A diversity of strategy?

14.16 Some stakeholders argue that the law on investment duties encourages “herding behaviour”. Where individuals seek to protect themselves against criticism by doing what everyone else is doing, legal duties may become a “lemming standard”. As Lord Myners said in 2010, “in this world, it is fine to be wrong or even lose money, as long as you do so in the company of others”.

14.17 The Network for Sustainable Financial Markets told us: The fiduciary duty of prudence has been understood as a mandate to favour the status quo, which has artificially suppressed demand for investment advisors and consultants to update their business models to address conceptual shortcomings and has discouraged fiduciaries from leaving the safety of the “investor herd”.

14.18 An investment manager or trustee may not be rewarded for acting contrary to the herd. ShareAction gave the example of investment managers who lost contracts in the 1990s because they foresaw the dot com bubble and refused to invest in technology equities. Herding may lead to an unhealthy focus on bench-mark relative performance, which encourages short-term investment. It may also increase systemic risk.

14.19 We think that where herding does occur it is mainly caused by the nature of human behaviour. This is exacerbated by an industry structure in which pension schemes rely on the advice of a small number of investment consultants and where investment managers are judged in relation to other investment managers. We do not think that herding is caused by trustees' legal duties, or that a change in the law would make a practical difference.

14.20 It is true that duties of care measure behaviour against that of others performing similar services. For example, professional trustees are judged against what "it is reasonable to expect of a person acting in the course of that kind of business or profession". In this sense trustees may be wise to look at general market practice. However, this should be tempered with a healthy dose of common sense; the standard does not measure behaviour simply against what others are doing but what a *reasonable* trustee would do.

14.21 Our provisional conclusion is that the law gives trustees considerable discretion to make their own decisions. So long as they keep the purpose of the power of investment in mind, consider relevant factors and follow the procedural requirements we have outlined, the courts will not second guess their decisions.

Q6: Do consultees agree that the law permits a sufficient diversity of strategies?

Comment: The Forum concurs with this conclusion. The challenge will be how far trustees receive independent advice to move outside the box imposed by the culture of their traditional advisers. The Forum believes that one of the crucial mechanisms required to generate new thinking by trustees is a different kind of trustee training: finding a more pluralist approach outside of the traditional voices of the industry is required.

Encouraging long-term investment strategies?

14.22 The Occupational Pension Scheme (Investment) Regulations 2005 set out the general legal principle: assets should be invested in a manner "appropriate to the nature and duration of the expected future retirement benefits payable under the scheme". Trustees are entitled to consider any factor which might impact on investment performance over this time frame.

14.23 As we noted in Chapter 2 there are many pressures on trustees which discourage long-term investment strategies. For DB schemes, these include the statutory funding objective and the need to show any deficit in the employer's company accounts based on accounting standards FRS17 or IAS19.

14.24 Furthermore, both DB and DC pension trusts are often small. They lack internal resources and are highly dependent on their investment consultants and investment managers. As Professor Kay put it, investment consultants are a source of short-termist behaviour "because they are typically making recommendations to trustees based on recent performance histories, rather than the future approach and strategy of the manager". They may also recommend complex arrangements which require further professional advice but make it difficult for trustees to oversee the strategy. Our provisional conclusion is that these sorts of pressures are the cause of short-term investment strategies – not the law of fiduciary duties.

Q7: Do consultees agree that the main pressures towards short-termism are not caused by the duty to invest in beneficiaries' best interests?

Comment: The Forum accepts this conclusion, but notes that in the face of the cultural pressures from investment consultants and external asset managers, trustees are up against a significant barrier when wishing to challenge such short-termist thinking. There would seem to be the need for making the challenge on a regular basis might fit comfortably within an extension of the duty of case, outlined above.

Allow investments in line with generally prevailing ethical standards?

14.25 As we have seen, trustees should consider ethical issues in only very limited circumstances. Trustees should not invest in activities which are illegal. Nor do we think that trustees should invest in activities which contravene international conventions. For example, trustees should not invest in firms manufacturing cluster bombs, banned by the Convention on Cluster Munitions.

14.26 Outside these narrow areas, however, ethical issues are highly contested. To take a recently debated example, some people think that payday lending at high interest rates is wrong, while others think that the ability to borrow money quickly for short periods provides a useful service. Moral condemnation of payday lending is not necessarily "generally prevailing".

14.27 As explained in Chapter 10, the current law permits trustees to disinvest from payday lending if they think that public condemnation of the practice will lead to a risk that the business model is unsustainable. But trustees should only disinvest for purely ethical reasons if two conditions are satisfied. Firstly, the trustees must have good reason to think that scheme members would share their outlook. Secondly, they should anticipate that the decision will not result in financial detriment to the scheme. In practice it is unlikely that trustees will be aware of members' views or that members will have common views unless the scheme is small and has members from a common source, such as a religious group.

14.28 The law requires trustees to focus on providing pensions to their members, setting aside their own political, moral or religious views. As Lord Murray observed in *Martin v City of Edinburgh District Council,* it is not reasonable or practicable for fiduciaries to divest themselves "of all personal preferences, of all political beliefs, of all moral, religious or other conscientiously held principles". Nevertheless, they must do their "best to exercise fair and impartial judgment" on the merits of the issue before them.14 We see advantages to legal rules which remind trustees that their duty is to provide pensions and not to improve the world in some general sense, possibly at the expense of their beneficiaries. We ask consultees whether they agree.

Q8: Do consultees agree that the law is right to allow trustees to consider ethical issues only in limited circumstances?

Comment: The Forum concurs with the Commission in its review of the options on these matters.

A balance of risk and benefit?

14.29 Trustees are required to balance risk and returns. The Occupational Pension Scheme (Investment) Regulations 2005 set out the general principle: the power of investment should be exercised in a manner “calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole”. The assets should 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”.

14.30 Some stakeholders argued that the Regulations require too much diversification. The Kay Review identified fragmented shareholding as a major factor in discouraging the effective engagement between shareholders and companies. As UNISON stated in their response to our short paper, “fiduciaries are legally bound to diversify assets, so that even the largest collective funds in the world must collaborate to exercise influence over corporate practice in any one company or sector”. Similarly, ShareAction told us that “prevailing interpretations of fiduciary duty may encourage excessive diversification”.

14.31 Diversification duties may also have pushed funds to diversify across managers and mandates. For example, at the turn of the century, the average externally managed pension fund had around three mandates whilst by 2010 they had nine. Inevitably, this creates greater potential for conflicts of interest throughout the chain and the need for greater oversight of those fulfilling delegated duties.

14.32 We welcome views on whether the current rules encourage excessive diversification. We also ask if the law provides the right balance of risk and return. We would be interested to know whether pension funds may be incurring hidden risks, for example in the recent move towards investments in swaps and derivatives, as part of liability driven investment strategies.

Q9: Does the law encourage excessive diversification?

Q10: Does the law encourage trustees to achieve the right balance of risk and return?

Q11: Are there any systemic areas of trustees’ investment strategies which pose undue risks?

Comment: There is considerable evidence from the research and analysis on the LGPS fund sector that greater complexity amongst investment management arrangements can be a significant factor in poor performance. This is particularly so with regard to an increasing number of mandates held by individual funds. We refer the Commission to the publication of State Street Global Analytics at: [to be sourced]

Is the law satisfactory?

14.33 Finally we ask whether the law works in the best interests of beneficiaries or whether it requires reform. We welcome views on this overarching question.

Q12: Overall, do consultees think that the legal obligations on trustees are conducive to investment strategies in the best interests of the ultimate beneficiaries?

Q13: If not, what specifically needs to be changed?

No Comment

Consolidation of pension funds

14.34 Finally, many stakeholders told us that the best means of encouraging long-term investment strategies would be to move towards greater consolidation within trust-based pension funds, both DB and DC funds. Consolidation was supported by, among others, the National Association of Pension Funds (NAPF), UNISON and the Fabian Society. We also note the major consolidation of the Australian pension market.

14.35 It was suggested that larger funds would provide economies of scale. Stakeholders drew our attention to the study by APG, the Dutch investment manager, into the investment performance of the Local Government Pension Scheme (LGPS) which suggested that "substantial improvement in investment performance could be realised by increasing the size of funds". Furthermore, larger funds would lead to more expert, better resourced trustees with the capacity to act as engaged shareholders.

14.36 We note that DWP consulted on this issue in July 2013.22 If consultees have further views on this issue we will pass those views to the relevant government departments.

Comment: Please see the study from State Street Analytics Research quoted above.

FIDUCIARY-TYPE DUTIES IN CONTRACT-BASED PENSION SCHEMES
Duties to review suitability

14.37 Pension trustees are under clear duties to consider and review their statement of investment principles. In Chapter 12 we highlighted that the duties on contract based pension providers are much less certain.

14.38 As we saw in Chapter 13, stakeholder pensions and pensions used for the purposes of auto-enrolment must offer a default investment option. In stakeholder pensions this must be "lifestyled". In other words, the investment strategy must be adjusted over time to reduce the risk of market volatility as the member nears retirement. For non-stakeholder pensions used for auto-enrolment, lifestyling is not a legal obligation, though it is good practice. Although trustees should review their statement of investment principles at least every three years, there is no equivalent requirement on contract-based providers to review the investment strategy applying to default funds. In July 2013, DWP consulted on whether reviews should take place regularly, at least every three years.

14.39 When a member makes an initial choice of investment strategy, the regulations appear to place the onus on the individual to review and update that choice, even though most people find decisions about pensions to be “complex, hard, unpleasant and time-consuming”.24 There is no clear responsibility on either the employer or the pension provider to tell the member that they have chosen an overly expensive or under-performing fund, which is no longer operating in their interest. The FCA rules impose some duties on providers to consider the suitability of decisions to trade for the end investor, but it is not clear how often investment strategies must be reassessed or when providers should seek new information about their scheme members.

14.40 Our provisional view is that the rules requiring contract-based pension providers to reassess the suitability of investment strategies over time should be clarified and strengthened, both for default schemes and for chosen schemes. This is to meet the principle in the Government’s response to the Kay Review that pension providers should act in the best long-term interests of their clients. We ask consultees for views.

Independent Governance Committees

14.41 In Chapter 13 we noted that following discussions with OFT and DWP, the Association of British Insurers (ABI) has agreed to introduce Independent Governance Committees embedded within insurance pension providers.

14.42 There are many difficult questions about how these committees will work, including how they will be appointed, resourced and supported in their work. Unlike trustees, the committees will not have the power to change investment strategies or fund managers. Instead they will make proposals to the pension provider’s board, who may act on the proposal or may explain why they do not propose to act. It remains to be seen how far the threat that committees will make their proposals public will influence pension providers.

14.43 Furthermore, it is not clear from the published material whether members of the committees will be under explicit legal duties to act in the interests of members – and if so, whether they can exclude liability for breaches of these duties.

14.44 Our tentative view is that members of the committees should be subject to clear legal duties to act in the interests of members. We appreciate, however, that if members carry unlimited personal liability for breaches of those duties it may be difficult to find individuals willing to carry out the task. We think that pension providers should provide a full indemnity to the members of their committees for any liabilities they incur. Pension providers are best placed to control the quality of the committees’ work. After all, they will appoint and resource the committees. An indemnity will give pension providers a clear interest in ensuring that the committees carry out their tasks correctly.

Q14: Do consultees agree that the duties on contract-based pension providers to act in the interests of scheme members should be clarified and strengthened?

Q15: 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?

Q16: Should members of Independent Governance Committees be subject to explicit legal duties to act in the interests of scheme members?

Q17: Should pension providers be obliged to indemnify members of Independent Governance Committees for liabilities incurred in the course of their duties?

No Comment

FIDUCIARY DUTIES IN THE REST OF THE INVESTMENT CHAIN

The debate

14.56 One of the key recommendations underpinning Professor Kay's ideas for reform was that non-excludable fiduciary standards should apply to all relationships in the investment chain which involve discretion over the investments of others or advice on investment decisions. This view was shared by Lord Myners who conducted a similarly comprehensive review of investment problems. In his evidence to the BIS Select Committee, Lord Myners felt that intermediaries should have fiduciary responsibilities to the end client:

"We need to place great clarity around the concept of the intermediary – the adviser – acting wholly and unquestionably in the best interest of the client. At the moment, we know that is not the case. The test is one of fairness and disclosure, and Kay himself makes the point that in, for instance, the area of what he calls "stock lending", disclosure is inadequate… There needs to be clarity about fiduciary responsibility, backed up by a tough regulatory regime that says: if you misbehave, you are out – and out for good."

14.57 Other stakeholders shared this view. In their response to our short paper, EIRIS commented that "there is a mutual dependence along the chain of mediation and prudence and loyalty apply to most, if not all stages of the chain". In her evidence to the BIS Select Committee, Anita Skipper of Aviva Investors stated that "the whole chain has to have the same sort of basis of duty, right through from the ultimate owner to the company". Equally, Chris Hitchen, Chief Executive of the Railways Pension Trustee Company, felt that Government intervention was needed to apply fiduciary duty throughout the investment chain, noting: At the moment it applies at my end of the chain but it does not apply at the transactional end, and Government intervention may be required to prevent it being stopped from going down the chain by contractual arrangements.

14.58 Others accepted that fiduciary duties should apply but thought that the duties should be subject to contractual modification. The IMA, in their written evidence to the BIS Select Committee, was clear that: As an agent, an asset manager has a fiduciary responsibility to its clients, as well as responsibilities derived both from contractual agreement and regulation. Combined with fee structures, these elements help to ensure that the manager acts in the client's best interest.

14.59 However, they felt that parties should be free to limit the scope of their obligations in contract. They stated:

We do not consider it would be sensible from the viewpoint of the UK's competitiveness to prohibit contractual modification of a range of, sometimes disputed, statements of fiduciary responsibility, developed through case law in many areas of business. It is essential that services can be tailored to the needs of global investors services from the UK, especially where the investor concerned has no interest in UK equity investment.

14.60 Others also felt that there were difficulties in requiring other intermediaries in the investment chain to fulfil fiduciary obligations. In their response to our short paper, the Chartered Financial Analyst Society of the United Kingdom (CFA UK) felt that agents providing investment services were not subject to the same level of duty to the end investor as fiduciaries. They commented that "it would not be possible" for agents providing investment services to meet fiduciary duties because:
Investment firms face conflicts on a daily basis. They are paid by their clients so profit from their position and act on behalf of more than one client so cannot meet an undivided loyalty rule.… It is only those that represent a single beneficiary that can and should meet the fiduciary standard.

The current law

14.61 As we discuss in Chapter 11, the current law is very different from the position advocated by Professor Kay and Lord Myners. We reached four conclusions:

(1) The law is far from clear: the law of fiduciary duties is extremely flexible but also inherently uncertain.
(2) The courts look at the contract first, and interpret the parties' duties to each other in line with the contract. For example, if a contract between two apparently sophisticated parties states that a sale is made on an "execution only" basis, the courts will not go behind the contract to imply duties that the seller should act in the interests of the buyer.
(3) The courts are highly influenced by the regulatory regime. They are reluctant to go beyond the rules set out by Parliament and regulators.
(4) The courts are cautious in finding that those in the investment chain owe duties to others outside the immediate contractual or trust-based relationship. The classic case is *Caparo Industries v Dickman*, where the House of Lords held that auditors owe duties only to the shareholders of the company which employs them as a body, and only for certain purposes: they have no duty of care to future investors.

Should the law of fiduciary duties be reformed generally?

14.62 We have considered whether there should be a general reform of the law of fiduciary duties to introduce more certain duties which cannot be excluded by contract. Our provisional view is that the law of fiduciary duties as such should not be reformed by statute. As we have seen, fiduciary duties are difficult to define and inherently flexible. We think that this is one of their essential characteristics: they form the background to other more definite duties, allowing the courts to intervene where the interests of justice require it.

14.63 As we saw in Chapter 1, the uncertainty surrounding the definition of fiduciary duties led the Government to avoid using the word "fiduciary" to provide clarity to the debate. The difficulties of using the word fiduciary would multiply if one were to attempt statutory reform. Any attempt to change fiduciary duties through legislation would result in new uncertainties and could have unintended consequences, especially for trusts.

14.64 If there is a need for greater clarity in some areas, we think it would be better to enact specific duties rather than attempt to codify an area of law which has always depended on the facts of the case. We ask if consultees agree.

Q18: Do consultees agree that the general law of fiduciary duties should not be reformed by statute?

Comment: It would be helpful if in its final report the Commission set out in more detail several of its ideas for reform in relation to codify specific duties, for example in relation to other intermediaries where a different provenance might apply, perhaps by FCA rulebook.

An alternative right to sue?

14.65 There is an argument that where investors suffer loss as a result of the wrongful actions of others, they should be compensated for their loss. This, it is said, would introduce a new ethos into financial markets and deter poor behaviour.

14.66 We have considered whether there are any ways in which such a reform might be introduced, other than through the reform of fiduciary duties. We think that the simplest way would be to extend rights to sue for breach of statutory duty under section 138D of the Financial Markets and Services Act 2000. At present, rights are limited: only a private person can bring an action, and only for breach of certain rules. The right could be extended to enable businesses to sue. It could also be extended to enable actions on the basis of the FCA Principles for Business. For example, Principle 6 states that: A firm must pay due regard to the interests of its customers and treat them fairly. Market participants could be given the right to sue any firm which had caused them loss by breaching this principle.

14.67 On the other hand, there are strong arguments against such a change. In practice trustees are allowed considerable discretion and are rarely liable unless they have acted unreasonably or dishonestly. It is unclear what would be achieved in practice by applying a similar approach along the investment chain.

14.68 Nor would increased rights to sue necessarily prevent misbehaviour. Civil litigation is inherently uncertain, costly and slow. As we have seen, some cases may take a decade or more to resolve. There is a danger that litigation would introduce greater costs, risks and instability after the event. It may also encourage defensive rather than good behaviour.

14.69 The courts are particularly concerned about extending duties to others outside the immediate contractual or trust-based relationship. In *Caparo*, Lord Bridge counselled against the creation of "liability in an indeterminate amount for an indeterminate time to an indeterminate class". Similarly, Lord Oliver was concerned about "a limitless vista of uninsurable risk".

14.70 Our provisional conclusion is that there should be no statutory extension of rights to sue within financial markets. The effect of any such change would be uncertain and potentially disruptive. It would add substantially to costs in the chain, including insurance and legal costs. However, we would welcome views on this issue.

Q19: Should rights to sue for breach of statutory duty under section 138D of the Financial Markets and Services Act 2000 be extended?

Comment: The Forum is of the view that it would be helpful for the Commission's final report to suggest further consideration of legal rights to redress in its conclusions.

Strengthening FCA rules

14.71 We have not been asked to review the FCA Handbook. That is a mammoth undertaking, which lies outside our expertise and resources. Our project sits alongside Recommendation 7 of the Kay Review that: Regulatory authorities at EU and domestic level should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions.

14.72 Nevertheless, our discussions with stakeholders emphasised the centrality of FCA regulation. Financial markets cannot function without good regulation. For example, the long term nature of pension funding means that it is impossible for scheme members or trustees to choose between products in the same way that they could choose between consumer durables. There were many areas in which stakeholders thought that current regulations were inadequate. As we discuss in Chapter 11, where the FCA rules impose clear duties, it is likely that the courts will interpret duties of care in line with these rules.

14.73 There are two issues where we seek views: the regulation of investment consultants and custodians. It is not our responsibility to recommend changes to FCA rules, but we will pass the responses we receive to BIS and the FCA for their consideration. We have not asked about investment managers' fees as the FCA is already conducting a thematic review. Nor do we ask about the Stewardship Code, as the Financial Reporting Council is currently reviewing the implementation of the Code.

Investment consultants

14.74 As we discuss in Chapter 12, stakeholders expressed concern about the apparent lack of regulation of investment consultants. Investment consultants appear not to fall within the FCA regulatory regime so long as they only give "generic advice". Questions were raised about potential conflicts of interest, so that an investment consultant's advice may not be independent. Instead, there is the possibility that the advice might be coloured by a particularly close relationship with an investment manager or the presence of an in-house offering. We conclude that the law on this issue is unclear.

Q20: Is there a need to review the regulation of investment consultants?

Comment: The Forum is of the view that the role and responsibilities of investment consultant would benefit from further detailed consideration by the Commission and the FCA. There is as yet no industry standard classification of consultants' performance or independent assessment of performance track record over time. Trustees' oversight and risk management responsibilities would be considerably enhanced if the consultants were subject to independent investigation.

Custodians

14.75 Today securities are often held electronically and indirectly. Shares are held through a chain of intermediaries. Instead of "owning" a share certificate, the investor is registered on the computer system of an intermediary, who in turn is registered on the computer system of a higher level custodian. The job of a custodian is simple: to hold the asset safely and to account for its ownership correctly. The world's financial markets depend on custodians carrying out this function honestly and efficiently. Two questions were raised about the role of custodians.

THE LEGAL FRAMEWORK

14.76 The first question concerns the legal framework under which intermediated shares are held. In the past there has been some debate over the legal relationship that governs this ownership structure. It can be viewed as either a back-to-back chain of creditor debtor relationships, or as a series of trusts, where each tier holds an interest for the benefit of those in the tier below. It now seems settled that the arrangement is trust-based, which protects the investor's interest if one party in the chain becomes insolvent. However, some areas of uncertainty remain.

14.77 In October 2009, UNIDROIT produced a convention on the underlying law of intermediated securities. From 2006 to 2008, the Law Commission analysed successive drafts of the convention. We advised the UK Government to sign and ratify the convention to bring legal clarity at an international level. However, the UNIDROIT Convention has not been ratified by any country. Similarly, whilst the European Commission has also been looking at the issue, no legislative proposals have yet been published. We are interested to know whether the law in this area needs to be reviewed to ensure that it is fit for purpose.

Q21: Is there a need to review the law of intermediated shareholdings?

Comment: The Forum is of the view that trustees would benefit from an independent review of the role and responsibilities of custodians. There are concerns that regulation and oversight of the custody businesses would benefit from such a review.

STOCK LENDING

14.78 The main controversy affecting custodians relates to stock lending. This is where custodians lend the client's investment to a third party, typically to enable the borrower to sell short. This introduces a risk that the borrower may default, though the custodian may obtain collateral to guard against this. Where there is an appropriate term in the contract, the custodian is entitled to retain the fee rather than rebating it to the client. Professor Kay recommended that "all income from stock lending should be disclosed and rebated to investors".

Q22: Should the FCA review the regulation of stock lending by custodians?

Comment: The Forum has concerns that stock lending is a virtually unregulated capital market transaction that has been particularly opaque. Problems and conflicts of interest in the proxy voting process have been particularly affected by the lack of transparency and lack of economic interest exhibited by prime brokerage operations that may have unwarranted and disproportionate impacts on proxy voting outcomes. An independent review with trustee input may be helpful here.