**By email**

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MACFARLANES

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Dear Sirs

**Response to the Law Commission's Consultation Paper on Fiduciary Duties of Investment Intermediaries**

1 **Macfarlanes LLP**

1.1 Macfarlanes LLP is a firm of lawyers whose clients include companies, pension scheme trustees and investment intermediaries. We welcome the opportunity to respond to the Law Commission's Consultation Paper "Fiduciary Duties of Investment Intermediaries" dated October 2013.

2 **Overview**

2.1 The genesis of the Consultation Paper is the Kay Review published in July 2012, which criticised "short termism" in UK equity markets and suggested that misunderstandings on the part of pension trustees and their advisers about the nature of fiduciary duties as they applied to investment were a contributory factor.

2.2 We believe that the current law is clear, does not inhibit the consideration of environmental social and governance (ESG) issues, and puts responsibility where it should sit – with pension trustees, whose wide range of responsibilities includes the prime duty to ensure that pension benefits which have been promised by the employer are delivered.

2.3 Pension trusts have been subject to considerable regulation over many years, and face the prospect of further change as a result of potential changes to the IORP Directive. While some further change may be necessary, unnecessary change should be avoided. Stability will better enable employers and schemes to confront the challenge of sustainable pension provision for current and future employees. Changes to the law in this area would also be likely to affect matters beyond pension investment, for example the law on family trusts and charities.

2.4 Where short termism exists, it is, in our view, more likely to be the result of the pension regulatory system than any uncertainty over the extent of fiduciary obligations. The Pensions Regulator requires deficits to be repaired as quickly as practicable in order to promote member security and protect the Pension Protection Fund. This, coupled with the regular monitoring of deficits and a mark to market approach, encourages trustees to avoid asset and liability mismatches and may discourage a long term view on investments or full recognition of ESG considerations. Since accounting standards also highlight the short term funding basis, it is

unsurprising that discussions on ESG considerations as a means of preserving long term shareholder value generally form part of an overall view of balanced risk and return rather than a separate objective in itself.

*Environmental, Social and Governance Factors*

2.5 We regard it important to distinguish between ESG considerations which have an impact on long term shareholder value, and a broader consideration of the public good. A better world is something most people aspire to and can agree on: the way in which that can be achieved is not. The current law allows asset holders with fiduciary responsibilities to make their own judgments on the interests of their beneficiaries. We very much favour that approach, since the trustees are ultimately accountable and must make all their decisions, including their investment decisions, with the particular circumstances of their particular scheme in mind. We would not favour a prescriptive approach which attempted to define certain ethical or public good requirements which needed to be observed. We believe that such an approach, undesirable in itself, could present temptation to politicians seeking sources of funding. While we believe that ESG considerations should be discussed by trustees, and clear instructions given to investment managers on the extent to which those considerations should be factored into the asset management process, those decisions are for the trustees. It may be that a more open discussion of what constitutes long term shareholder value could be initiated by investment advisers, and greater clarity included in the scheme SIP.

2.6 It is also important to remember that defined benefit employers provide an open ended guarantee of benefits which have been promised, and that pension trustees owe a duty to the employer as well as to their members. This dual responsibility is acknowledged, in the trustees' obligation to consult the employer on investment policy, and underpinned in the relevant investment regulations. In the latter, it is only where a conflict exists that the trustees must exercise their powers solely in the members' interests.

2.7 Given our view that trustee responsibility and accountability is key, we do not believe that any new provision which would limit current investment flexibility, perhaps by requiring that beneficiaries are consulted, would be desirable. Clearly there are schemes in which members are given investment choice, and the timely and accurate implementation of their wishes is the trustees' responsibility. Other than in these cases (or in those very limited cases referred to in case-law where adult actual and potential beneficiaries all agree on potential restrictions) such an approach could in any event present material practical difficulties. For example it will not be possible for trustees of a large scheme to determine the (no doubt diverging) ethical views of all members, and the weight given to certain ESG factors inevitably changes over time.

*Extension of fiduciary duties*

2.8 In our view, it would not be appropriate to extend fiduciary duties to other actors in the investment chain. The burden placed on actors other than trustees would be disproportionate particularly where regulation is already provided by the Financial Conduct Authority (the "**FCA**"). We also believe that where fiduciary relationships may already exist alongside a contractual relationship (for example between an investment manager and the trustees by whom the manager is appointed) the fiduciary duty should not be extended to scheme members. To do so would be incompatible with the trustees' responsibility and accountability, whose policy decisions and instructions to the investment manager will reflect their wider responsibility for all aspects of the scheme, including its financial viability. There would also be a risk of conflict as only one party/person can take ultimate responsibility for any one decision.

2.9 Neither is it appropriate to impose a specific fiduciary duty on employers in the context of auto-enrolment or pension provision in general. Employers owe a duty of care to their employees and a duty of good faith is implied into employment contracts. As such, further duties are not required and would be disproportionate particularly for employers for whom auto-enrolment is

compulsory. Where there are particular issues, for example excessive commissions payable to an employer, these are better addressed specifically either under financial services legislation or auto-enrolment legislation (as has been done in relation to consultancy charges).

2.10 We agree with the concept of Independent Governance Committees (as now adopted by the Association of British Insurers) but are concerned that the specific legal duties on such committees, as well as their make-up, must be clearly defined and not excessively onerous. In particular:

2.10.1 if there is to be any specific personal liability on the members of the committee then thought must be given to the appropriate protection of such members when acting in good faith; and

2.10.2 the duty imposed should not go further than the duties that trustees of occupational defined contribution schemes are currently subject to. The duties of such trustees extend to the selection of an appropriate 'menu' of fund choices for members but do not require a review of the suitability of each member's investment choice. Members should be encouraged to seek independent financial advice (in much the same way as they are, or should be, when they come to purchase an annuity).

2.11 We do accept that concern has been expressed by some in relation to the regulation of investment consultants. Occupational pension scheme trustees need to take 'proper advice' before exercising their investment powers under s.36 of the Pensions Act 1995. In practice, most trustees will follow the advice provided by the investment consultants, who may not be regulated by the FCA insofar as their advice is generic. We do not consider that a fiduciary duty should be imposed on such investment consultants whose unregulated advice is likely to be a small part of what they do, but we do think it is important to ensure that the trustees are relying on appropriate advice and are adequately protected as a result of that reliance.

## 3 Responses to specific questions

*Pension trustees' duties to act in the best interests of beneficiaries*

3.1 **Do consultees agree that Chapter 10 of the Consultation Paper represents a correct statement of the current law?**

Yes. We would add that we also consider that trustees of defined benefit pension schemes have a duty to the sponsoring employer as well as the members (*Edge v Pensions Ombudsman [2000] Ch. 602*). This is not merely because the sponsoring employer is a residual beneficiary of the trust. Rather, it is an acknowledgment of the impact of the open ended balance of cost responsibility on the employer's business and cash flow.

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

We agree that the law as it currently stands reflects an appropriate understanding of beneficiaries' best interests.

3.3 **Do consultees think that the law is sufficiently certain?**

Yes. The flexibility that the law permits counter-balances any uncertainty.

3.4 **Should the Occupational Pension Schemes (Investment) Regulations 2005 be extended to all trust-based pension schemes?**

Running a small trust-based scheme (for example, a small self-administered scheme) is expensive and the administrative burdens are large. Where possible, such schemes should benefit from deregulation so that their burden can be reduced. Of course, there is a balance to be struck with ensuring that such schemes operate to the benefit of their members, however, we consider that the law on fiduciary duties, the general trust law and the tax regime provide sufficient safeguards in this regard. Accordingly, we consider that the Occupational Pension Schemes (Investment) Regulations 2005 should not be extended to cover all trust-based pension schemes.

3.5 **Are there any specific areas where the law would benefit from statutory clarification?**

As noted above, the current flexibility in the law allows it to achieve its objectives notwithstanding the different circumstances in which it applies. We do not consider that statutory clarification is required.

3.6 **Do consultees agree that the law permits a sufficient diversity of strategies?**

Yes.

3.7 **Do consultees agree that the main pressures toward short-termism are not caused by the duty to invest in beneficiaries' best interests?**

3.7.1 Short term investment strategies are an industry wide issue and the result of a number of factors (such as the pensions funding regime, regular reporting and accounting standards) and not directly related to the duty to invest in the beneficiaries' best interests.

3.7.2 In addition, short term investment strategies are not always inappropriate, for example beneficiaries may have different interests (perhaps as between young and old members of a pension scheme). Schemes may also be looking at short term returns for a wider strategic reason, such as achieving a buy out of their liabilities.

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

Yes. The circumstances that can be taken into account are (i) where they have an impact on the value or long term viability of an investment (particularly, for example, where the investee company places a high value on its brand) and (ii) at the direction of the relevant beneficiary (e.g. where he or she is exercising an option under scheme rules, or in very limited cases referred to in case-law where adult actual and potential beneficiaries all agree on potential restrictions). In the context of defined benefit pension schemes, the employer's interest is specifically acknowledged.

3.9 **Does the law encourage excessive diversification?**

We do not have a view on this question.

3.10 **Does the law encourage trustees to achieve the right balance of risk and return?**

We do not have a view on this question.

3.11 **Are there any systemic areas of trustees' investment strategies which pose undue risks?**

We do not have a view on this question.

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

Yes.

3.13 **If not, what specifically needs to be changed?**

*Fiduciary-type duties in contract-based pension schemes*

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

We consider that the duties of the pension provider owed under the general law of contract and negligence as well as their obligations under financial services legislation provide sufficient clarity and strength. A fiduciary duty is only enforceable when the member in relation to whom the duty is breached brings a claim and there a numerous reasons (uncertainty, costs and a lack of understanding being uppermost) as to why members may not enforce their rights.

3.15 **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?**

We have noted in our Overview that it is important that any duties imposed on pension providers should be consistent with the current obligations of trustees. We suggest that it should be clear that any new duty does not require the provider to review each member's fund choices.

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

The usefulness of such committees would be reduced if they were not subject to explicit legal duties to act in the interests of scheme members. However, it should not be left to the member to enforce these duties (as is the case with fiduciary duties) and the relevant regulator should provide the required oversight.

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

As noted in our Overview, we consider that thought must be given to the appropriate protection of such members when acting in good faith.

*Fiduciary duties in the rest of the investment chain*

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

Yes.

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

No. We agree with the Law Commission's reasoning on this point.

3.20 **Is there a need to review the regulation of investment consultants?**

As noted in our Overview, we do consider that the regulation of investment consultants could be a cause for concern and that trustees should be adequately protected in their dealings with them.

3.21 **Is there a need to review the law of intermediated shareholdings?**

We consider that the position must be a series of trusts as outlined in paragraph 3.58 of the consultation paper; if there is any doubt about this analysis it should be clarified. Such clarification would be most sensibly achieved at EU, if not international, level given the cross border nature of the custodian industry.

3.22 **Should the FCA review the regulation of stock lending by custodians?**

A separate confidential response has been submitted previously in relation to this question.

3.23 **Do you have any other comments about fiduciary duties in the investment chain, or how those duties are applied in practice?**

No.

Yours faithfully

Macfarlanes LLP