FairPensions™
The campaign for **responsible** investment

Fairshare Educational Foundation
Trowbray House
108 Weston Street
London SE1 3QB
020 7403 7800
fairpensions.org.uk

Financial Services Bill: Second Reading Briefing

With the launch of auto-enrolment this year, millions more people will be saving for a pension through the capital markets, many of them low-paid workers. Recent months have seen concerns that pension savers' interests are not always put first by the industry, with the spotlight turning onto excessive and untransparent charges[1] and conflicts of interest.[2]

This briefing focuses on Part 2 of the Financial Services Bill, which establishes the new consumer regulator, the Financial Conduct Authority (FCA). The FCA will be responsible for regulating asset managers, including those managing funds on behalf of pension schemes and individual pension savers. It is vital that the FCA is properly equipped to ensure that these savers' interests are protected.

Summary

- The investment industry's duties to pension savers are currently poorly understood and applied. The government's efforts to rebalance the Bill by making the FCA have regard to firms' duty of care are welcome, but do not go far enough. We recommend an explicit reference in the Bill to firms' fiduciary duties to clients. This would give the FCA a powerful tool to combat market abuses and ensure consumers' interests are protected.
- The Bill does not refer to 'stewardship', i.e. shareholders' exercise of ownership rights in major companies, despite this being an important part of regulators' response to the financial crisis. We recommend that the Bill should make clear where this agenda sits in the regulatory framework, to ensure that it does not fall between the cracks of the new architecture.
- The Bill obliges the FCA to continue the FSA's three industry panels (compared to only one consumer panel), despite these being described in evidence to the Joint Committee as "*essentially legacies of the old self-regulatory arrangements*". We recommend that this requirement should be removed.

1) Investment firms' responsibilities to savers

The issue

The fund management industry's duties to savers appear to be poorly understood and observed. As the Law Commission has confirmed, where firms are managing other people's money or giving financial advice, they have strict fiduciary duties to act in those people's interests (see box below).[3] This includes both individual clients and institutions such as pension funds who represent large numbers of underlying savers. Yet this fact is not generally accepted within the industry. Moreover, because these are common law duties, they do not form part of the FSA's regulatory approach. An explicit reference to fiduciary duty in the Financial Services Bill would give the FCA a powerful tool to ensure consumers' interests are protected.

[1] 'Revealed: how City fees are eating into our pensions', Guardian, 17/12/2011. http://www.guardian.co.uk/business/2011/dec/17/treasury-warned-over-traders-fees
[2] Wong S., 'How conflicts of interest thwart institutional investor stewardship', Butterworths Journal of International Banking and Financial Law, September 2011
[3] Law Commission, 1992, 'Consultation Paper No. 124: Fiduciary Duties and Regulatory Rules' (HMSO), paras 2.4.7 & 2.4.14

What is fiduciary duty?
A fiduciary is someone who acts on behalf of another in circumstances which give rise to a relationship of trust and confidence. Fiduciaries must act in their clients' best interests, must avoid conflicts of interest and may not profit from their trust without the client's consent. These duties are stricter than FSA rules.

Effectively, fiduciary duties require those entrusted with other people's money to put those people first, and not to exploit their position to make an unfair profit. If these duties were properly observed and enforced, it would mark a sea change in the prevailing culture of the financial services industry – one which would lead to better outcomes for consumers.

Examples where consumers are suffering from fiduciary duties not being observed include:

- *Unauthorised profits*. Recent research has shown that fund managers make significant profits from lending out clients' shares, with only two-thirds of the income from these activities returned to the fund.[4] Under fiduciary duties, this may be unlawful, as any such profit should go back to the underlying investors.
- *Exercise of shareholder rights*. Asset managers acting on behalf of pension savers should exercise their voting rights at major companies in the best interests of the savers, without regard for the interests of the firm. Yet there is anecdotal evidence of fund managers being told by their superiors to wave through excessive CEO pay to avoid upsetting potential clients.[5] In this way the interests of the business are placed ahead of those of the savers whose money is at stake.

A requirement for the FCA to 'have regard' to firms' fiduciary duties would give it the scope and the tools to combat such abuses and to encourage higher standards of ethical behaviour in financial services.

Problems with the current Bill
During pre-legislative scrutiny, concerns were raised that the Draft Bill was unbalanced, enshrining the principle that consumers are responsible for their decisions but not placing any equivalent responsibility on firms. The Joint Committee on the Draft Bill recommended that the Bill *"place a clear responsibility on firms to act honestly, fairly and professionally in the best interests of their customers."*[6] The Financial Services Consumer Panel meanwhile recommended that this should take the form of an explicit fiduciary duty to clients.[7]

In response, the government has inserted a new principle to which the FCA must have regard: that "*those providing regulated financial services should be expected to provide consumers with a level of care that is appropriate*", having regard to the risks involved and to consumer capabilities.[8]

However, the Bill's new wording may still not provide a high enough level of protection for consumers, since it lacks clarity on what might constitute an 'appropriate' level of care. In particular, it stops short of confirming that those managing other people's money owe fiduciary duties. This would be the clearest and most effective way of achieving the Joint Committee's intention.

FairPensions recommends the insertion of an explicit clarification that, where firms are exercising discretion over clients' assets, the appropriate standard of care will be a fiduciary standard.

[4] 'Fund managers make millions from lending clients' shares, study shows', Guardian, 31/08/2011. http://www.guardian.co.uk/business/2011/aug/31/stock-lending-short-selling
[5] See for example Wong S. (footnote 2)
[6] Joint Committee Report, para 126
[7] Joint Committee Report, para 117; Written Evidence from Financial Services Consumer Panel
[8] Clause 5: New Clause 1C(2)(e) of FSMA (page 16, line 44)

2) Stewardship and 'responsible capitalism'

The issue

In the aftermath of the financial crisis, it was widely recognised that major institutional investors had behaved as 'absentee landlords', not doing enough to challenge risky behaviour at the banks they owned. This had direct consequences for many of the pension savers whose money these shareholders invested: according to the OECD, in the year after the crisis pension funds lost an average 17% of their value.[9]

Following a recommendation from the post-crisis Walker Review,[10] the Financial Reporting Council (FRC) established the UK Stewardship Code,[11] designed to encourage investors to behave as active owners of the companies in which they invest. This agenda is increasingly recognised as vital to building a more stable and responsible capitalism, with both government[12] and opposition[13] emphasising the need for shareholders to exercise greater oversight of, for example, executive pay. Yet the FSA currently treats this as marginal, appearing not to regard it as a consumer issue, despite its obvious implications for consumer outcomes.

Problems with the current Bill

There is no mention of stewardship in the current Bill, although it is clearly relevant to the objectives of both the PRA and the FCA:

- Under the UK corporate governance regime, shareholders have the primary responsibility for ensuring that companies – including banks – are well-run. If regulators do not take an interest in how shareholders discharge this responsibility, we risk a double regulatory failure.
- Consumer outcomes for the millions of pension savers soon to be auto-enrolled will depend in part on their agents making sure that the companies they invest in are well-run and manage risks effectively – including systemic risks with potential impacts on the entire fund.

There is a danger that stewardship will continue to fall between the cracks in the new regulatory architecture. The PRA is likely to take little interest because the firms in question (ordinary asset managers) are FCA-regulated. Yet there is little reason to assume the FCA will accord this issue a higher priority than the FSA does at present. The proposed duty of co-ordination will do little to resolve this, since it is focussed on reducing the burden of regulation on dual-regulated firms, rather than on preventing gaps in regulation between the two new authorities.

FairPensions recommends that the Bill should make explicit reference to the importance of stewardship and should make clear where it expects this to be dealt with in the new regulatory architecture. This could be achieved by amending the FCA's 'have-regards', its rule-making powers, or its duty to co-ordinate with the PRA. Alternatively, both regulators could be given a new duty to co-ordinate with the FRC, which oversees the UK Stewardship Code.

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[9] 'Pensions In a Crisis: How should retirement-income systems respond to financial market turmoil?', OECD. http://www.oecd.org/dataoecd/52/52/42204972.pdf

[10] Recommendations 16 & 17; Final Report available at http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf

[11] FRC, UK Stewardship Code, available at http://www.frc.org.uk/images/uploaded/documents/UK%20Stewardship%20Code%20July%2020103.pdf

[12] HC Deb, 23 January 2012, c23; HC Deb, 24 January 2012, c7WS

[13] Chuka Umunna, 12/01/12, Speech to the High Pay Commission. Available at http://www.totalpolitics.com/speeches/labour/labour-politics-general/288962/chuka-umunna-on-executive-pay.thtml

3) Preventing regulatory capture

The issue

At present the FSA's consultation with industry far outweighs its interaction with consumers. Civil society and consumer groups, including ourselves, often find it difficult to engage with the FSA. If the new FCA is to fulfil its role as a 'consumer champion' it is vital that this balance changes.

Problems with the current Bill

The Bill proposes to replicate the FSA's current arrangements, with three standing industry panels (the Practitioner Panel, the Smaller Business Practitioner Panel and the Markets Practitioner Panel) and one consumer panel.[14]

The Joint Committee on the Draft Bill considered whether the PRA should also establish consultative panels. It concluded that it should not, expressing particular concern that *"an obligation to create such panels could lead to regulatory capture."*[15] Its report quotes evidence from the Bank of England which described the FSA's panels as *"essentially legacies of the old self-regulatory arrangements that preceded FSMA".*[16] Mervyn King emphasised that *"although the Bank intended to* consult *industry, it was not* accountable *to industry".*[17]

If the FSA's practitioner panels are a 'legacy of self-regulation', it is difficult to see why it was thought appropriate to retain them for the new FCA, whose establishment is intended to herald a more robust and consumer-oriented approach.

FairPensions recommends that, in line with the Joint Committee's recommendation regarding the PRA, the FCA should not be legally obliged to maintain three industry panels as against one consumer panel.

About FairPensions

FairPensions is a registered charity that promotes Responsible Investment (RI) by pension schemes and fund managers, and seeks to ensure that the City acts in the long-term best interests of savers. RI generally involves shareholder engagement with companies to ensure that environmental, social and corporate governance (ESG) risks with the potential to affect long-term financial returns are monitored and managed.

FairPensions publishes research including widely-respected industry benchmarking surveys. Our single-issue campaigns help turn the spotlight onto hitherto neglected areas where there is a strong business case for investor engagement. We also work with policymakers to improve transparency and accountability to savers, and to remove regulatory barriers to RI.

We are a member organisation, whose members include representatives of pension savers (such as the National Federation of Occupational Pensioners, UNITE and Unison), a number of leading UK charities (including Oxfam, Amnesty International and WWF), and thousands of individual pension fund members. We are independent of industry and are funded by grants from charitable foundations and trusts.

Further information

For more information and suggested amendments relating to the above, please contact: Christine Berry | Policy Officer, FairPensions | christine.berry@fairpensions.org.uk | 0207 403 7833

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[14] Clause 5: New Clauses 1N-1Q of FSMA, pages 21-22
[15] Joint Committee Report, para 336
[16] Joint Committee Report, para 334
[17] Ibid