ShareAction
the movement for Responsible Investment

Law Commission Consultation on Fiduciary Duties of Investment Intermediaries

Response from ShareAction

Executive summary

The current law

We broadly agree that Chapter 10 represents a correct statement of the current law, although we have some queries on points of detail and on the Commission's characterisation of how these principles might apply in practice.

- We welcome the Commission's clarification that fiduciary investors may consider ESG issues (on the basis of their impact on companies' financial performance) and macroeconomic or systemic issues (on the basis of their impact on the portfolio as a whole), and indeed that investors should consider their policy on such issues. However, in places the consultation paper appears to mischaracterise what this means for pension funds in practice – for example, when it suggests that ESG integration is incompatible with passive investment strategies.
- We also welcome the Commission's confirmation that fiduciary investors are not solely restricted to the consideration of beneficiaries' financial interests, but may have regard to their non-financial interests (such as quality of life) and to their ethical views, provided that this does not result in significant financial detriment to the fund, thus compromising the purpose of the trust. However, we disagree with the Commission's conclusion that it will be "rare" for this to be appropriate in practice. For example, both legal theory and practical experience suggests that it is eminently possible for trustees to identify widely held ethical concerns amongst their beneficiaries, and to translate these into prudent ethical investment policies which do not compromise financial returns.
- We are concerned by the Commission's approach to stewardship. We do not agree that stewardship is only cost-effective for the largest funds: whilst this may be true of direct engagement with companies, smaller funds can instead seek to appoint fund managers with strong stewardship capabilities, set general policies to inform these decisions, and monitor their fund managers' stewardship activity alongside more conventional performance criteria. In addition, suggesting that small funds are legally obliged to 'free-ride' on the stewardship efforts of larger funds directly undermines the UK Stewardship Code, and by extension the foundations of the UK corporate governance regime.

In our view it would be helpful for the Commission to provide a more holistic statement of the current law which brings together the various issues discussed in Chapter 10. Not doing this could inadvertently promote a 'silo' mentality which does not map on to the realities of investment decision-making, perpetuating a risk-averse culture which fails to see the wood for the trees. This would be contrary to the present review's purpose of clarifying that the law gives trustees the flexibility to exercise their discretion having regard to a range of relevant factors.

The law as interpreted in practice

We refer to the review's terms of reference, which ask whether there are problems with fiduciary duties "as established in law or as applied in practice". Whilst we agree that fiduciary duties as established in law are not fundamentally problematic, in our experience there is a disconnect between the view of the law set out by the Commission and the way the law is applied in practice. We disagree with the Commission's conclusion that this problem is not real or significant.

Firstly, in our experience UK pension funds overwhelmingly believe that the law prohibits them from considering non-financial factors at all. Secondly, the concern to avoid being seen to make decisions on the basis of non-financial factors leads many funds to take a narrow view of the duty to protect beneficiaries' financial best interests: it is assumed that adherence to the duties of loyalty and prudence can best be demonstrated by frequent monitoring of financial performance and rigid adherence to received wisdom and the advice of consultants. This exacerbates the tendency to focus on short-term returns and avoid activities which may improve long-term returns but lack a demonstrable and immediate financial benefit (such as stewardship activity or ESG integration).

In our view (and that of Professor Kay), it is clear that this dynamic is not conducive to investment strategies which serve beneficiaries' best interests. We are not primarily concerned with questions of liability and do not disagree with any of the Commission's conclusions about situations in which trustees might be held liable. Neither do we disagree that short-termism has many other causes which are unrelated to fiduciary duties. However, we are concerned that fiduciary duties are widely held to justify, or even require, investment strategies which actively undermine beneficiaries' long-term interests. There is an urgent need to clarify the law to ensure that trustees are authorised to behave in a more enlightened way.

The law as it should be

We have proposed statutory clarification on a permissive (as opposed to a prescriptive) basis, confirming that trustees *may* have regard to a wide range of factors provided that they remain focussed on their beneficiaries and do not prejudice beneficiaries' financial interests. In our view this is necessary to overcome the 'reckless caution' of the legal advice trustees tend to receive when the law is uncertain or ambiguous. Stating the Law Commission's view of the legal position will be helpful but not sufficient.

We understand the Commission's concern to avoid undermining the flexibility inherent in the law of equity. However, in our view the present situation offers neither flexibility nor certainty. The perception that the law is ambiguous results in cautious legal advice and a belief that it is 'safer' to adhere rigidly to received wisdom. Permissive clarification along the lines we propose would enhance, not restrict, trustees' flexibility to exercise their discretion in judging what will serve their beneficiaries' interests. In addition, our approach could easily be adapted to focus solely on clarifying the duties of pension fund trustees if the Commission remains reluctant to enter the business of defining who is a fiduciary.

There are three specific areas in which we think the law needs to be changed rather than simply clarified:

- We do not agree with the Commission's implicit conclusion that the 'duty to gazump' is appropriate for major market participants, or that there is no role for the law in surmounting collective action problems. In our view, fiduciary investors should be authorised to adopt standards of conduct which they believe would serve their beneficiaries' interests if generally adopted, even if other market participants are not doing the same.
- If the Commission's view of the law regarding stewardship is accurate, then there is clearly

a need for the law to be changed, since this view fundamentally undermines the UK corporate governance regime and the interests of beneficiaries taken as a whole.

- The 'Londonderry Rule', which states that fiduciaries do not have to give an account of their decisions to beneficiaries, is not appropriate in a pension fund context where savers have paid for their benefits. This should be made explicit.

In addition, we would like to see a shift of emphasis in the Commission's framing of the law. The consultation paper plays down the duty to take all relevant factors into account while placing great emphasis on the duty to act in line with the purposes of the trust. Given that it is not always possible to reliably measure the impact of individual 'non-financial' factors on financial returns, this risks perpetuating the belief that on balance it is safer not to have regard to these less tangible factors. We understand the Commission's concern to avoid diluting trustees' focus on securing a pension for their beneficiaries. However, the prevailing fixation on short-term financial returns has singularly failed to achieve this objective, and indeed has actively undermined it. The dangers of an overly restrictive approach to fiduciary duties are clearly at least as significant as those of an overly liberal approach.

We also think that the meaning of 'the purpose of the trust' in a pensions context could usefully be clarified. A pension pot is a means to an end, not an end in itself: the 'underlying purpose' of a pension fund is to provide beneficiaries with a retirement income capable of underpinning a decent standard of living. This is not identical with the maximisation of portfolio returns. Arguably, pension funds, like charities, should not be obliged to invest in ways which directly undermine the underlying purpose of their trust.

Fiduciary duties of contract-based providers

We agree with the Commission that the duties on contract-based providers should be clarified and strengthened. Although we agree that the absence of ongoing monitoring of investments is the crux of the problem, we are not wholly convinced that a specific regulatory requirement to review fund suitability on a regular basis will be sufficient to address this problem. Nor are we convinced of the merits of purely advisory 'Independent Governance Committees'. In our view, any new governance bodies should have not only a duty to act in members' best interests, but also the power to make decisions about the scheme. If this is not deemed feasible, there is a strong case for preferring (or even requiring) trust-based schemes over contract-based, as under the Australian system.

Fiduciary duties along the investment chain

The consultation paper notes that the current legal position is not that which Professor Kay advocated. In our view this entails some public policy problems and further steps are needed to address them. For example, FCA rules should protect small 'unsophisticated' pension funds from contractual limitations on fiduciary duties in the same way that retail clients are currently protected. They should also impose high standards as regards the avoidance and management of conflicts of interest, which should be actively enforced.

Whilst we agree that the courts may not be the best vehicle for regulating market conduct, we do think that fiduciary standards of care provide a useful backstop to detailed regulatory box-ticking. We continue to believe that there would be value in clarifying and strengthening the duties of investment intermediaries towards their clients, ideally through legislation. We do not suggest a wholesale codification or reform of the general law of fiduciary duties.

We agree that the regulation of investment consultants should be reviewed, given their significant influence on pension funds' investment strategies and the potential for conflicts of interest to arise.

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

We broadly agree with the Commission's characterisation of the current law in Chapter 10, namely that

(a) trustees may consider environmental, social and governance (ESG) issues in light of their impact on company performance, as well as macroeconomic and systemic issues which may affect the performance of their portfolio as a whole, as part of their duty to protect beneficiaries' financial interests; indeed, trustees should consider in general terms their approach to these matters; and

(b) trustees are not restricted solely to the consideration of beneficiaries' financial interests, but may also consider non-financial interests such as beneficiaries' future quality of life or ethical views, insofar as this does not compromise the trust's primary purpose of securing financial returns.

However, we would query some details of the Commission's position. Here as elsewhere in this paper, our focus is not only on the legal principles at issue, but also on what these principles mean in practice, and how the guidance provided by the Commission in this regard is likely to be interpreted by market participants. Below we consider each of the five categories discussed in Chapter 10 in turn, as well as the Commission's approach to stewardship. We then make some more general comments.

<u>Environmental, social and governance (ESG) factors</u>

We welcome the Commission's clarification that fiduciary investors may, and arguably should, consider ESG factors when making decisions, given the body of evidence on their financial impact.

We have some comments on the Commission's characterisation of what this means in practice. The consultation paper tends to treat ESG as a 'style' of investing, rather than as a set of investment criteria which can be applied to any style of investing. For example, paragraph 10.46 refers to positive screening, negative screening and 'best in class' as the key methods of ESG integration. This does not capture the type of ESG integration practised by an increasing number of mainstream investors, whereby ESG criteria are routinely factored into investment analysis and corporate governance activity, but without the application of specific ESG 'screens'. In addition, this characterisation focuses almost exclusively on stock selection, and does not mention shareholder engagement on ESG issues with the aim of adding value at company level. This leads to the assumption that only actively managed funds can take an ESG approach (for example at paragraph 10.64, where the paper says that investors seeking to reduce costs "may decide… simply to track an index"). In addition to shareholder engagement, passive investors can use ESG-tilted indices to reduce their exposure to ESG risks: it is therefore a false dichotomy to contrast ESG investing with passive investing.

As a result, the consultation paper gives the impression that trustees face a one-off choice whether to 'take an ESG approach', and that 'choosing' this style of investing is likely to be inappropriate for many funds, particularly those seeking to reduce costs. This does not quite match the reality of how such issues arise in fund decision-making. Whilst it is true that "considering a wide range of factors costs money" (paragraph 10.64), the choice for most pension funds will not be simply to 'consider ESG factors' or 'not consider ESG factors' and then seek out products accordingly (although if trustees do undertake an exercise of articulating their 'investment beliefs', as is now considered best practice, they should certainly consider their investment beliefs regarding ESG). Rather, ESG capability should be one of the range of criteria on which potential fund managers are judged during manager selection, alongside other criteria such as cost.

Even small funds which do not feel able to 'pay' for ESG integration may find that one manager offers more robust ESG integration than another for the same cost, and may make this a deciding factor between the two. Larger funds or those with strong investment beliefs regarding ESG may decide that this is something they are willing to pay for, and will weight these criteria accordingly during manager selection processes. In either case, this process can apply regardless of whether the mandates in question are actively or passively managed. An obvious example is the National Employment Savings Trust (NEST), whose investment strategy is designed to keep costs low and is largely passive, but which has strong investment beliefs regarding the importance of ESG factors, implemented through manager selection and through the appointment of engagement overlay providers.

Given the Commission's hope that it can "remove th[e] misconception" that ESG integration is incompatible with fiduciary duty (paragraph 10.59), we think it is important that the Commission's final report is as clear as possible about what ESG investing means for pension schemes and when consideration of ESG factors may be necessary or appropriate.

<u>Macroeconomic factors</u>
We welcome the Commission's clarification that macroeconomic and systemic factors can be considered by fiduciary investors, and indeed that trustees should consider whether to take account of such factors (although in the latter case, similar considerations apply to those discussed above in relation to ESG issues). We particularly welcome the confirmation given in the summary paper that "it is permissible to accept a lesser return in some areas where this is justified by the benefits to the portfolio as a whole" (page 21). Although we note that this precise wording is not repeated in the full consultation paper, we believe that it is an important and helpful clarification about the role of 'universal owner' thinking for fiduciary investors, and hope that it will be reiterated in the Commission's final report.

We would also note that this view of the law is not, in our experience, the view taken by most pension funds – including many large and well-resourced institutions. This is a particularly clear example of where the legal position in theory does not appear to correspond to the application of fiduciary duties in practice. Indeed, consideration by institutional investors of macroeconomic and systemic issues lags far behind the integration of company-level ESG data, on which the Commission draws similar conclusions. In our view, this strengthens the case for explicit legislative clarification (see our responses to questions 3, 5 and 12).

<u>Quality of life factors</u>
We also welcome the Commission's clarification that fiduciary investors may take into account their beneficiaries' broader interests, including impacts on their quality of life now or in the future, provided that this does not compromise their primary objective of securing financial returns. We also agree with the Commission's characterisation of the 'tie-break' in this context, drawing on *Harries v. Church Commissioners,* as a matter for trustees' judgement rather than a precise mathematical calculation. (Having said this, our comments below in relation to meaning of the ethical tie-break in practice apply here as well.) We particularly welcome the Commission's statement that:

"*The courts have not required trustees to restrict themselves to the metrics of modern portfolio theory. They do not demand that an efficiency frontier is improved through greater and greater diversification. As we have seen, trustees may instead make broad judgments based on a wide* *range of factors, including ESG factors and the effect of investments on the economy as a whole."* (paragraph 10.87)

In our view this is an extremely important principle to establish, not just in relation to quality of life factors, but as a general guide to trustee decision-making on investment matters. Again, it is not a principle that in our experience is widely understood or accepted (see our responses to questions 3, 5 and 12).

As with ESG factors, we have some reservations about the Commission's characterisation of what these principles mean in practice: for example, in its consideration of our 'takeover' example, which concludes that "trustees should only take into account the fact that some members would lose their job where this would not cause financial detriment to the fund. Otherwise, trustees are in the invidious position of prioritising some members' interests over others." (paragraph 10.97) Whilst we agree with this in principle (provided that the Commission has in mind the broader concept of 'significant financial detriment' discussed above), we would characterise the impartiality issue slightly differently.

Whichever decision trustees make in this context, they will be prioritising the interests of some beneficiaries over others: indeed, the fact that the interests of different classes of beneficiary will sometimes irrevocably conflict is the purpose of the duty of impartiality. For example, younger beneficiaries with longer time horizons will be better served by investment strategies which prioritise sustainability of returns, while older beneficiaries close to retirement will have an interest in the maximisation of short-term returns even at the expense of the long term. As we see it, in this particular case trustees would be weighing a relatively small (given the level of diversification of most portfolios) and uncertain (given the body of evidence that most takeovers do not add value) financial benefit to *all* beneficiaries with a potentially severe detriment to a small number of beneficiaries. How these factors weighed in the balance would depend on the precise facts of the case and should be a matter for trustees' discretion.

Of course, the consultation paper distinguishes this type of case on the basis that "where one group's quality of life factors will be another group's financial loss, the law appears to be that trustees should concentrate on financial returns" (paragraph 10.97). However, the reality is not quite this simple. Losing one's job is not only a quality of life issue but also constitutes a significant financial loss. In our previous submission we characterised it as an example of beneficiaries' wider 'economic' interests – but of course, it is also worth noting that a beneficiary who has lost their job is no longer contributing to their pension or receiving employer contributions. This can therefore also be regarded as relevant to beneficiaries' *financial* interests.

There is precedent for pension funds interpreting their duty to protect beneficiaries' financial interests in terms of their expected retirement outcomes, taking into account their propensity to contribute, rather than narrowly in terms of the return on their contributions. For example, NEST's research into its target demographic found that they exhibited a low tolerance for downside risk; they therefore designed their investment strategy so as to reduce the likelihood of extreme shocks in the early stages which could put members off saving altogether. NEST was criticised in some quarters for this, because conventional investment wisdom dictated that these early stages were precisely when members should be taking on more risk in the expectation of higher returns. However, whether or not its strategy is correct is clearly a matter for trustee discretion rather than a question for the courts: there can be no doubt that NEST had the financial best interests of its beneficiaries at heart. They simply recognised that 'financial best interests' are not identical with 'financial returns'. Further below we offer some comments on the question of 'acting for the purpose for which the power is given' which we believe are relevant in this context.

Ethical investment

Although we broadly agree with the Commission's statement of the law in this area (namely, that ethical issues can be considered provided that they reflect the beneficiaries' values, as opposed to those of the trustees, and that doing so does not result in significant financial detriment to the fund), we have concerns about the Commission's characterisation of this in practice. We have reserved these comments for our response to question 8; here we confine ourselves to two specific comments on points of law:

(1) We are unclear as to the legal grounds for singling out charity pension funds for special treatment, as the consultation paper does in paragraph 10.111. We had understood that the principle articulated in *Harries v. Church Commissioners*, that charities should avoid making investments which conflict with their aims, referred to charitable endowments rather than charity pension funds – since in the former case the power of investment is given for the 'underlying purpose' of promoting the aims of the charity, as opposed to the provision of financial benefits to staff of the charity. Whilst charities may wish to avoid investments which conflict with their mission on the basis that this undermines their beneficiaries' work, this is not dependent on the sponsoring employer's charitable status: charity workers are not the only class of beneficiary who value the integrity of the work they do, as is demonstrated by periodic beneficiary-driven controversies about healthcare workers or medical researchers being invested in tobacco. As such, the relevant considerations here would be the general ones which the consultation paper outlines in 10.113 – 10.116, rather than the special considerations outlined in *Harries v. Church Commissioners* in relation to charitable investments.

(2) We also disagree with the Commission's characterisation of ethical issues as being "unrelated to… the interests of beneficiaries" (paragraph 10.110). The Commission rightly notes that "trustees should not pursue their own moral, ethical or political purposes with their beneficiaries' money" (paragraph 10.109) and that trustees contemplating taking an ethical position "must have good reason to think that scheme members would share the moral viewpoint" (paragraph 10.116). However, in our view, this is simply another way of saying that 'moral benefit' is an aspect of the beneficiaries' 'best interests' or 'benefit' in the same way as (for example) quality of life, and that the fiduciary duty of loyalty applies to this class of benefit just as it does to any other. Implicit in Sir Robert Megarry's notion of the ethical tie-break is the idea that an appropriate ethical investment policy would confer a 'moral benefit' on some beneficiaries without imposing a financial disadvantage on others: such a policy, while "gratifying the majority, will neither harm nor benefit the minority, and so will in general be for the benefit of the beneficiaries at large".[1]

    We are concerned that treating ethical issues as "unrelated" to beneficiaries' interests reflects an assumption that the driving force behind most ethical policies is likely to be trustees seeking to "make moral statements" which serve their own views at the expense of their beneficiaries, and that the principal role of the law is to restrain these impulses. This is reflected in the language of the consultation paper even in the passages which stress the

[1] Sir Robert Megarry. 1989. "Investing Pension Funds: The Mineworkers Case". Youden (ed.) *Equity, Fiduciaries and Trusts (1989)* [pp.] 149-159

primacy of beneficiaries' views – for example, the reference to the need for beneficiaries to "share" the moral view implicitly assumes that it will originate with the trustee. Whilst this is undoubtedly the case for some funds, on the whole it is not our experience. As discussed in response to question 8, the scenario we are concerned about is that in which beneficiaries themselves raise an ethical issue about the use of their money, and are told that the trustees cannot even engage in debate about it because to do so would be contrary to their fiduciary duties. In our view, this perspective could provide an important balance to the Commission's current approach to ethical investment.

Beneficiaries' views

We welcome the Commission's confirmation that fiduciaries can take beneficiaries' views into account, and that to do so is not inconsistent with fiduciary obligation provided that trustees "make the ultimate decision" (paragraph 10.121). However, it is unfortunate that this section of the consultation paper is rather brief and does not consider the particular legal issues posed by pension funds in this regard (discussed in the forthcoming paper 'The Voice of the Beneficiary', which has been provided to the Commission).[2] We will not attempt to rehearse these issues here: however, in brief, we believe there is a strong case for making a distinction between pension funds and private family trusts on the basis that pension savers, one way or another, have paid for their benefits. As such, pension beneficiaries have a particularly strong claim to have their views taken into account by their fiduciaries.

We think that there is a further important dimension here: more consultation with beneficiaries is closely linked to more accountability by trustees. Indeed, we would see such proactive and reactive interactions as the two sides of the same coin. Active beneficiaries could usefully support regulation in improving the governance of schemes, with scrutiny from below supplementing supervision from above. In this context, we would refer also to our comments below in response to Questions 12 & 13, in relation to trustee accountability and the rule in *re Londonderry*.

Stewardship

We are surprised and concerned by the Commission's approach to stewardship, which we would regard alongside ESG issues and macroeconomic issues as among the things which trustees should consider when developing their investment strategies. In particular, we strongly disagree with the Commission's conclusion that stewardship is likely to be inappropriate for all but the largest funds, and even for these funds is merely "one possible tool" (paragraph 10.40). This conclusion appears numerous times in Chapter 10, which states that "small and medium funds lack the resources needed for stewardship activities (paragraph 10.39), that "all but the very largest schemes lack the internal resources or the financial clout to have much effect (paragraph 10.38) and therefore that "it is difficult for any but the largest pension funds to justify the costs of monitoring firms' complex decision-making" (paragraph 10.76).

This appears to stem from a misconception that stewardship entails direct monitoring and engagement with companies. In fact, where pension funds are concerned, stewardship more often entails the appointment and monitoring of asset managers with strong stewardship capabilities, who in turn take responsibility for day-to-day engagement with companies. As with ESG integration, this is eminently feasible for smaller schemes. As the National Association of Pension Funds puts it:

[2] Also discussed in ShareAction's recent publication, 'Our Money, Our Business', available online at http://www.shareaction.org/sites/default/files/uploaded_files/investorresources/OMOB.pdf

"Whilst stewardship activities can be prohibitively expensive at the fund level, trustees are more frequently delegating the day to day responsibility for stewardship to their investment managers, a model recognised by the UK Stewardship Code. The fund managers are then asked to report back to the trustees on these matters as part of their performance reporting."[3]
It is also worth noting that small funds can pool their stewardship activities without having to undergo the more complex process of pooling their assets (as recommended by the Commission in Chapter 13). Examples of this include the recently-established Trade Union Share Owners group, which will exercise voting rights according to a common policy on behalf of a group of relatively small trade union pension schemes,[4] and the Local Authority Pension Fund Forum.

On this basis, we are concerned that the Commission's statement of the current law as regards fiduciaries' scope to undertake stewardship activity is unduly restrictive. It is also at odds with UK corporate governance policy of the last fifteen years or more. The Myners Review argued in 2001 that where engagement was in beneficiaries' interests, it was *"arguably already a legal duty of both pension fund trustees and their fund managers to pursue such strategies"* but that to put this beyond doubt, *"the principle should in due course be more clearly incorporated into UK law."*[5] As an interim measure, Myners recommended that pension fund mandates should incorporate the principle of the US Department of Labour's interpretive bulletin, issued under ERISA, which stated that:

"The fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares... The fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the value of the plan's investments."[6]

In the event, Myners' recommendation for explicit legal clarification was not adopted, with the government instead deciding to pursue the voluntary route which has led to the UK Stewardship Code. The idea that long-term asset owners can and should accept stewardship responsibilities remains a central plank of UK corporate governance. This history suggests, firstly, that the Commission's interpretation of the law is contestable, and, secondly, that if this interpretation is indeed correct, the law may need to be changed to bring it into line with accepted best practice and the UK corporate governance regime. We discuss this further in our response to question 12.

General comments

- The Commission places a great deal of emphasis on **the duty to act in accordance with the purposes of the trust**, for which the power of investment was given. We agree with this interpretation of the law, but believe that the law allows for a broader approach to the 'purpose of the trust' in a pension fund context. In particular, we would emphasise that the purpose of a pension fund is to provide beneficiaries with a retirement income capable of underpinning a decent standard of living. This is not identical with the maximisation of portfolio returns, and, as the Kay Review observed, an interpretation of the law which equates these two things may not serve beneficiaries' best interests (see our responses to

[3] NAPF, 2013, 'Law Commission review of fiduciary duties of investment intermediaries: The NAPF's preliminary response'.
[4] See TUSO/TUC, 2013, 'Trade union voting and engagement guidelines', available at http://www.tuc.org.uk/sites/default/files/tucfiles/TUC_Trade_Union_Voting_and_Engagement_Guidelines_March_2013.pdf
[5] Lord Myners, 2001, 'Institutional Investment in the United Kingdom: A Review', paras 5.89 and 5.115
[6] US Department of Labour, 29CFR 2509.94-2

questions 2 and 12).

As the consultation paper notes, *Harries v Church Commissioners* established the principle that charitable investors may have regard to the **'underlying purpose'** of the power of investment, namely to further the aims of the charity. But, as we argue in Chapter 4 of 'Protecting our Best Interests', it is not only charities for whom investment returns are a means to an end. Portfolios do not exist in a vacuum: they have value only insofar as they translate into actual spending power for beneficiaries in retirement, and thus into a better standard of living. In our view, this is a helpful way of thinking about the macroeconomic and quality of life issues which the Commission discusses in Chapter 10, and it would be helpful to set these issues explicitly in this context. This could help to guard against a crude interpretation of the law which promotes blind adherence to abstract models based on narrow and short-termist investment criteria (which, as the paper argues in paragraph 10.87, is a misinterpretation of the legal position).

- The consultation paper takes a very relaxed approach to the duty to take all relevant considerations into account, for example stressing that it is "not necessarily an onerous duty" (paragraph 10.30). By contrast, it takes an extremely strict and cautious approach to the duty to exercise investment powers for a proper purpose. We agree that this reflects the likely approach that would be taken by the courts (although we think that this is not certain and could be subject to debate). However, we are not convinced that this state of affairs is conducive to the best interests of beneficiaries, financial or non-financial – as discussed in our responses to questions 2 and 12.

- We are surprised that the Commission does not discuss the implications of the **duty of impartiality** in relation to the issue of short-termism. Given the genesis of the present review in the Kay Review, and in light of recent work on the duty of impartiality as between younger and older members (for example by Keith Johnson),[7] this would seem to be relevant to the review's terms of reference.

- Finally, we feel there would be value in providing a **more holistic statement** of the current law. Whilst we welcome the thoroughness with which the Commission has identified and separated the various distinct issues at stake, we feel that Chapter 10 would have benefitted from a more substantive summary which draws together the various threads discussed in the chapter. Not doing this could inadvertently promote a 'silo' mentality which does not map on to the realities of investment decision-making and perpetuate a risk-averse culture which fails to see the wood for the trees.
  In practice, most issues which trustee boards will consider do not fit neatly into one of the above 'boxes' but will cut across many: for example, climate change will have significant impacts on individual companies' financial performance, on the economy as a whole, and on beneficiaries' quality of life; many beneficiaries will also regard it as a moral issue. Trustees should consider such issues in light of all these many facets, rather than considering each facet in isolation, potentially leading to the conclusion that none of them

[7] See for example Johnson, K. 2010, 'Back to the Future of Pension Fund Trust Fiduciary Duties' (available online at www.fairpensions.org.uk/sites/default/files/uploaded_files/KeithJohnsonFiduciaryDuty.pdf); Hawley, Johnson & Waitzer, 'Reclaiming Fiduciary Duty Balance,' Rotman International Journal of Pension Management, September 2011 (Vol 4, No. 2, Page 4)

creates a sufficiently compelling case for action.

Another example is the Commission's consideration of our 'takeover' scenario. As discussed above, this scenario brings into play a range of different interests – financial, economic and wider – and cannot be fully understood simply as a trade-off between 'one group's financial interests' and 'another group's quality of life factors'. Likewise, if climate change affects the future cost of food and fuel, this effectively reduces the real value of beneficiaries' pension pots, and so is a financial issue as well as a 'quality of life' issue. A more holistic approach is needed if trustees are to deliberate on such questions in a meaningful way. Of course, the separate sections of Chapter 10 are the building blocks of such an approach – but they need to be assembled into a coherent whole.

In our view it would therefore be helpful for the Commission to set out a more general statement of the current law. We would characterise the position as follows:

"Trustees have a duty to act in the best interests of beneficiaries and in line with the purposes of their trust, which in the case of a pension fund is to provide beneficiaries with a pension in order to fund a decent retirement. Courts will generally not second guess decisions taken properly and in good faith about how this should be achieved. In considering what will best serve beneficiaries' financial interests, a range of factors beyond short-term financial performance may be relevant – for example, ESG issues, macroeconomic factors and systemic financial risks. However, trustees are not solely restricted to consideration of beneficiaries' financial interests: they can take into account purely non-financial factors provided that this does not compromise their primary aim of generating financial returns. Exactly how these various different factors should be weighed in a way which optimises the interests of beneficiaries as a whole is a matter for trustees' judgement."

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

Broadly speaking, we agree – assuming that we have correctly understood the Law Commission's statement of the current law to be that the law does not oblige 'best interests' to be interpreted solely in terms of financial best interests, but allows trustees to take a broader approach provided that this does not compromise the purpose of the trust. (We would also refer to our comments in response to question 1 about the interpretation of the 'purpose of the trust' in a pension fund context, an issue which is not directly explored in the consultation paper.)

However, in our experience this is not the understanding of beneficiaries' best interests which is held by most market participants (see response to question 3). Our experience is that fiduciary investors overwhelmingly perceive the law as restricting them solely to the consideration of financial interests. In this respect there is a disconnect between fiduciary duties as established in law and as applied in practice, and, in our view, a need for explicit legislative clarification to help overcome this.

Moreover, this disconnect has the potential to damage beneficiaries' interests – including their financial interests – since it inevitably leads investors to be cautious about paying heed to 'intangible' factors which may have enormous impacts on financial return, but whose impact cannot be readily monetised or demonstrated in the short term. Examples of this include the benefits of stewardship activity and the financial risks posed by issues such as climate change. We discuss this further in our response to question 12.

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

No. In our experience, there is considerable uncertainty and confusion about the application of the law in practice. We share Professor Kay's view that, while the actual legal position is largely sound, there is an urgent need to "address uncertainties and misunderstandings on the part of trustees and their advisors."[8] In addition, some areas of the law are genuinely somewhat ambiguous, for example in relation to ethical investment (discussed below) or the extent to which trustees may have regard to the 'underlying purpose' of their trust (discussed in response to question 1). For all these reasons, we continue to believe that explicit statutory clarification is necessary.

The consultation paper does not consider at great length the question of how the law is interpreted and applied by pension funds in practice. However, it concludes that "decisions about what may or must be taken into account when making an investment decision are not primarily curbed by perceptions about the law" (paragraph 2.43). If by this the Commission means that it does not regard uncertainty or narrow interpretations of the law as a problem in practice, then we disagree.

For example, when we analyse pension funds' responses to member emails about environmental and social issues, confusion and misinterpretations of fiduciary duty are repeatedly evident. In our response to the stakeholder paper we summarised evidence from responses to emails about oil sands in 2010.[9] We will not repeat that analysis here, but one response in particular stands out:

"*The Trustees have a legal duty to not only invest, but to actively seek the best possible financial return … even if it is contrary to the personal, moral, political or social views of the trustees or beneficiaries. This was demonstrated in the Cowan v Scargill (1984) court case."*

This response typifies three key problems with current interpretations and invocations of the law:

(1) The conflation of material ESG issues with purely moral issues. The fund in question had received an email asking how it intended to vote on shareholder resolutions about BP and Shell's oil sands projects. The resolutions were based on concerns about financial risks, and the member's email was couched in those terms. The fund did not engage with these concerns but instead treated the issue as a 'moral' one and therefore outside the scope of its fiduciary obligations.

(2) The conflation of the distinction between financial and non-financial interests with the distinction between trustees' personal views and beneficiaries' views. The fund invokes a duty to "seek the best possible financial return" as a barrier to considering non-financial concerns "of the trustees *or beneficiaries"*, thereby implying that any consideration of non-financial issues – even if based on the views of beneficiaries themselves – would be a breach of the duty of loyalty. In our view (and, as we understand it, in the Commission's view) this is a mistake. As Berry & Scanlan conclude in 'The Voice of the Beneficiary': *"Cowan v. Scargill* confirmed the important principle that trustees cannot pursue a personal crusade with their beneficiaries' money. Its invocation as a barrier to considering beneficiaries' own views about the management of their money represents a different principle altogether."

[8] Kay Review Recommendation 9
[9] See ShareAction response to stakeholder paper p5; full analysis in The Voice of the Beneficiary, forthcoming

(3) The reference to *Cowan v. Scargill* in support of the above two conclusions illustrates the stagnation caused by the paucity of relevant cases in recent decades. In our experience funds frequently invoke this case – in our view, wrongly – to support a very narrow view of fiduciary duty.

To be clear, our concern in this case is not that the fund should necessarily have supported the resolutions or acted on the beneficiary's views. They might have sound reasons for not doing so, for example that they or their fund managers did not believe the issue in question to be material, or that they felt the costs of engaging on this issue would outweigh the benefits. However, responses which invoke fiduciary duty rarely set out any such reasons. Instead, they wrongly proclaim that the law prohibits them from even considering the matter at hand.

Our most recent comparable analysis suggests that this problem persists. In response to member emails asking about their position on climate change, 25% of funds referenced fiduciary duty – half as a reason to act on climate change, the other half as a reason to ignore it.[10] In our view, there could scarcely be a better demonstration of the continuing confusion that surrounds this question.

It is also notable that, where the consultation paper considers specific cases of advice given to pension funds, in almost all cases it reaches a conclusion at odds with that of the pension fund concerned. For example, in the takeover scenario, it concludes that wider impacts on beneficiaries may be considered if this does not result in (significant) financial detriment to the fund; as we noted in our response to the stakeholder paper, we understand that a major UK multi-employer scheme received advice that such factors could not be taken into account at all. Likewise, the Commission concludes that beneficiaries' ethical views can be taken into account if this does not result in significant financial detriment, and suggests that this is in line with the advice given by DLA Piper to USS. However, as we have already noted in discussions with the Commission, this does not appear to be the interpretation of the advice taken by USS themselves. A page on the USS website which refers to the advice states:

"*USS is unlike retail ethical or socially responsible investment funds which enable individuals to express their personal values in their investments. USS is not permitted to make investment decisions based purely on an ethical or moral stance. The fund has developed an active engagement approach and does not undertake ethical screening or operate exclusion policies. The rationale against a divestment approach is expanded in the following section and considered in the legal guidance provided USS's lawyers in September 2006.* "[11]

Although it could be argued that the word 'purely' is theoretically compatible with an acceptance of the ethical tie-break, it seems clear to us in context that USS takes the view that it is not permitted to develop investment policies which take ethical issues into account for their own sake (as opposed to taking into account financially relevant ESG issues). As we have indicated to the Commission, in our view this is a correct reading of the legal advice, although an incorrect reading of the law itself. For example, the advice states that trustees may exclude on ESG grounds if these have a "*current*

[10] Unpublished research (forthcoming) – available on request
[11] http://www.uss.co.uk/UssInvestments/Responsibleinvestment/BackgroundRationale/Pages/default.aspx

or potential impact on an actual or contemplated investment".[12] It stresses that in such cases, the decision to exclude would have been taken on financial rather than ethical grounds, and suggests that in the absence of such impact, trustees should not exclude investments on "extraneous" moral grounds. It does not directly address the question of whether such exclusions might be acceptable if they do not result in significant financial detriment.

Ultimately, the fact that ShareAction, USS, DLA Piper and the Law Commission appear to have reached such a range of different conclusions both as to the law itself and the meaning of the DLA Piper advice illustrates the potential for confusion and ambiguity in this area. On this basis, we feel that there is a particular need for explicit clarification of the law in relation to ethical investment (see response to question 5). Whatever one's views on the desirability of ethical investment strategies by pension funds, clarification is desirable: the prevailing uncertainty means that individual funds' approaches are more likely to be determined by the personal inclinations of the trustees, and hence may either go too far, or may inappropriately dismiss beneficiaries' ethical concerns.

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

Clearly, there is a balance to be struck here between ensuring that members of all pension schemes receive adequate protection whilst not imposing undue burdens on small schemes which are unable to cope with them. However, the requirements of the investment regulations are not onerous. Indeed, it could be argued that schemes which are genuinely too small to meet these obligations are not capable of serving their beneficiaries' best interests, and that a public policy of consolidation (as pursued in Australia) is the best course of action. If the investment regulations were extended to cover all trust-based schemes, small schemes could be subject to a transitional exemption over the projected period of consolidation to alleviate the dangers of over-regulation.

It is also worth noting that wholly-insured schemes are exempt from some aspects of the regulations, which, given the concerns over governance within insurance companies (see our response to questions 14 and 15), is perhaps cause for concern. The requirement to prepare a Statement of Investment Principles is also applied inconsistently across trust- and contract-based schemes, since stakeholder pension schemes are subject to this requirement but other group personal pension schemes are not.[13] We have previously suggested that there is a need for greater consistency not just among trust-based schemes but across all types of pension scheme.

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

<u>ShareAction's proposals for statutory clarification</u>

We remain of the view that there is a need for explicit statutory clarification of the scope of beneficiaries' best interests, and the extent to which trustees may have regard to factors beyond short-term returns. We produced draft legislation illustrating how this might work in practice in

[12] Paragraph 3.2, DLA Piper Advice to USS (2006), http://www.uss.co.uk/Documents/Legal%20advice%20to%20USS%20on%20RI%20from%20DLA%20Piper%20Sept06.pdf

[13] See page 22 of 'Our Money Our Business'

'The Enlightened Shareholder'.[14] To be clear, we do not propose prescriptive requirements on trustees to consider particular factors. Rather, our draft takes a permissive approach which clarifies that trustees *may* take a broader range of factors into account, provided that they remain focussed on their beneficiaries and on the purposes of the trust. The aim would be to give trustees confidence to exercise their discretion and judgement in determining what will best serve their beneficiaries' interests, rather than feeling constrained by outdated and unduly narrow interpretations of the law.

Specifically, we suggested that such legislation could clarify that trustees may have regard to:

(a) the likely consequences of any investment activities in the long term,
(b) the impact of any investment activities on the financial system and the economy,
(c) social and environmental considerations, including
(i) the implications of social and environmental factors for return on investments, and
(ii) the impact of any investment activities on communities and the environment,
(d) the implications of any investment activities for beneficiaries' quality of life, and
(e) the views, including the ethical views, of beneficiaries.

Our draft is partly modelled on section 172 of the Companies Act 2006, since there are strong parallels between the problem that measure was designed to solve and the problem under consideration here (namely, that in both cases common law duties are being interpreted unduly narrowly, and that this constrains the scope for market participants to pursue 'enlightened shareholder value'). The key differences are that we have adapted the list of 'have regards' to the investment context, and have taken a permissive rather than prescriptive approach ('may' rather than 'must'). Experts we spoke to during our 2010 research project on fiduciary duty felt that the value of section 172 was largely in the *permission* it granted to directors who wished to take a more enlightened view of their responsibilities, rather than in creating any truly enforceable new duties.[15] Our draft makes this explicit, since it is not part of our intention to create new duties or burdens on trustees.

Our draft attempted to cover all those managing pension savings on behalf of others, including contract-based providers, based on our view that it was desirable to create more consistency between the obligations of trust- and contract-based pension schemes towards their beneficiaries. However, if the Law Commission remains of the view that statutory clarification of the duties of other intermediaries is not desirable, this approach could be adapted to focus solely on clarifying the duties of pension fund trustees. In this case, we believe that this could be implemented through changes to the investment regulations.

The case for statutory clarification

We set out in detail the case for statutory clarification along these lines in our second response to the Kay Review's call for evidence.[16] We will not rehearse these arguments in detail here. However, the key point is that, in our experience, uncertainty about the law arises not just from poorly educated trustees but from overly cautious or even inaccurate legal advice. In our view, this is unlikely to change without explicit statutory clarification.

[14] Available online at http://www.fairpensions.org.uk/sites/default/files/uploaded_files/policy/EnlightenedFiduciaryReport.pdf
[15] See Chapter 6 of 'Protecting our Best Interests: Rediscovering Fiduciary Obligation', available online at http://www.shareaction.org/sites/default/files/uploaded_files/fidduty/FPProtectingOurBestInterests.pdf
[16] http://www.shareaction.org/sites/default/files/uploaded_files/KayReviewII.pdf , pages 2-4

We understand the Commission's concern to avoid undermining the flexibility inherent in the law of equity, and its conclusion that "it is worth preserving this flexibility, even if the result is some uncertainty." (paragraph 14.12) However, in our view the present situation offers neither flexibility nor certainty. The perception that the law is ambiguous results in cautious legal advice and a belief that it is 'safer' to adhere rigidly to received wisdom, almost regardless of outcomes for beneficiaries. Indeed, concerns that the law was being interpreted in a dangerously restrictive way were at the heart of the Kay Review's recommendation for the present review. Permissive clarification along the lines we propose would enhance, not restrict, trustees' flexibility to exercise their discretion in judging what will serve their beneficiaries' interests.

Nor do we believe that enshrining these principles in legislation would impede the ability of the law to evolve over time. It is worth noting that the very reason why *Cowan v. Scargill* casts such a long shadow over debates about responsible and sustainable investment is that there have been so few relevant cases before or since. Indeed, the last case directly on point of which we are aware (apart from *Harries v. Church Commissioners* in 1992) was *Martin v City of Edinburgh District Council* in 1988. In the 25 years since then, there have been at least five Pensions Acts, in addition to countless updates to regulations. If anything, the common law has proved itself *less* flexible and adaptable than legislation in this area, rather than more so. As a result, prevailing interpretations of the law are failing to keep pace with evolving best practice and emerging risks to pension savers' interests.

Indeed, in our view the statutory clarification we propose would be no different from previous updates to the investment regulations which have clarified or codified particular aspects of trustees' investment duties – for example, the introduction of the duty to diversify or the ending of the closed-list system.[17] It would not amount to a wholesale codification of fiduciary duties – the prospect which seems to worry some stakeholders. As the consultation paper notes, in Australia clarificatory legislation has been passed to "make explicit matters which were previously implicit" (paragraph 14.13). In our view, our proposals fall largely into this category. We can therefore see no clear case against permissive statutory clarification along the lines we propose in 'The Enlightened Shareholder.' (NB In response to question 13, we discuss some specific areas in which we think the law does need to be changed rather than simply clarified.)

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

As with many other aspects of our response, we feel that the distinction made in the Commission's terms of reference between fiduciary duties "as established in law" and "as applied in practice" is of vital importance here. Whilst the commission may be right that the prudent man principle does not require trustees to 'herd', and the paper's statement to this effect is helpful, (a) we do not believe this is entirely clear or uncontested, and (b) it is not how the duty is widely interpreted in practice.

Indeed, the consultation paper hints at this issue when it says that "in practice, the more unusual the decision, the more trustees will need to show that they reached their decision in the right way" (paragraph 10.29). This contributes to the tendency identified by Lord Myners for fiduciary investors to be extremely nervous of departing from prevailing market practices (referred to by the consultation paper at paragraph 14.16). In our 2010 research project, we were told that trustees'

[17] Trustee Investments Act 1961, Section 6(1)(a), Pensions Act 1995, Section 34.

fear of incurring liability contributes to making the pensions industry extremely slow to change, and thus slow to come to terms with new and emerging risks to beneficiaries' interests, such as climate change or systemic financial risk.

Of course, we do not dispute the Commission's conclusion that herding is "mainly caused by the nature of human behaviour" (paragraph 14.19), and that changing the law would not by itself resolve the problem. As with short-termism, there are clearly many interlocking factors which contribute to herding behaviour in financial markets (see response to question 7). However, in our view it is clearly unacceptable if major market participants interpret their legal obligations in ways which *exacerbate* rather than *mitigate* this problem. In our view, providing a statutory, non-exclusive list of factors which trustees may take into account (as suggested in response to question 5), along with a renewed emphasis on the importance of correct *process* in determining whether trustees have exercised their discretion appropriately, would help to redress the balance and give fiduciaries more confidence to depart from the herd when the interests of their beneficiaries demanded it.

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

It is difficult to disagree with this statement as framed, but we would query this framing. Firstly, the Kay Review did not suggest that fiduciary duties were responsible for the "main pressures" towards short-termism: like the Commission, he recognised that it was a complex and intractable problem with multiple causes. However, he did conclude that prevailing interpretations of the law were exacerbating the problem:

"some pension fund trustees equated their fiduciary responsibilities with a narrow interpretation of the interests of their beneficiaries which focused on maximising financial returns over a short timescale and prevented the consideration of longer term factors which might impact on company performance, including questions of sustainability or environmental and social impact."[18]

Secondly, the Kay Review did not identify "the duty to invest in beneficiaries' best interests" as the source of the problem. On the contrary, as the consultation paper notes, he felt that this core fiduciary duty should be the basis for all relationships in the investment chain. This was the context for his concerns that, in practice, fiduciary duty has been interpreted in ways which are counterproductive and could actually harm beneficiaries' best interests:

"While we believe that the common law provides clarity on what is meant by core fiduciary duties of loyalty and prudence, we believe that there is a need to clarify how these duties should be applied in the context of investment, given the widespread concerns about how these standards are interpreted."[19]

We agree with Professor Kay on both these counts. Thus, although we naturally agree with the Commission that there are many factors which contribute to the short-termism of financial markets, we do not believe that this undermines the argument that interpretations of fiduciary duty are also problematic and that this problem needs to be resolved. (The Commission singles out accounting standards as the main cause of short-termism; although these are clearly an important

[18] Kay Review para 9.20
[19] Kay Review para 9.22

factor, there are many others, from incentive structures within the investment chain to cultural norms to the natural desire to measure and monitor performance on a regular basis.)

In our view, an overly restrictive approach to the duty to protect beneficiaries' financial interests inevitably results in an over-reliance on short-term financial performance measurements as a means of operationalising this duty: how else are trustees to feel confident that they can be seen to be fulfilling their obligations? A correct and sound belief in the importance of remaining focussed on beneficiaries' financial interests too easily morphs into an incorrect and potentially disastrous belief that it is safer to ignore issues which cannot be demonstrably linked to financial performance in the here and now. Thus the large pension fund who received legal advice that their policy of voting all shares held might be unlawful since they could not demonstrate that this delivered a monetisable benefit to the fund – notwithstanding the fund's carefully considered belief that good stewardship is vital to long-term financial returns.

Another example of this mentality can be seen in one fund's response to a member email about 2010's shareholder resolutions on oil sands, which said: *"We also have as our main duty the financial interests of our members and so must not be seen to be making decisions based on other criteria."* As discussed above, these resolutions were firmly focussed on financial risks: indeed, ironically, many of the issues raised by the resolutions (such as poor oversight of contractors) foreshadowed the causes of the Deepwater Horizon oil spill which soon afterwards brought BP to the brink of insolvency, with significant financial consequences for many UK pension schemes who relied heavily on this company as a secure dividend payer. It appears that pension funds would rather ignore a potentially material financial risk than 'be seen to be' making decisions on non-financial grounds.

As discussed in response to questions 1 and 12, we are concerned that the Commission's choice of emphasis may exacerbate rather than mitigate this problem. The consultation paper emphasises that the duty to take all relevant factors into account is not an onerous one, while the duty to act in line with the purpose of the trust is restrictive and must be taken extremely seriously. This risks reinforcing precisely those aspects of the status quo about which Kay was most concerned: many trustees will continue to feel that 'playing it safe' means blindly adhering to consultants' advice and monitoring financial performance on a frequent basis, and that on balance it is safer not to have regard to less tangible factors which may well affect long-term returns but which could be deemed 'non-financial'.

In our view this 'reckless caution' is a serious and urgent concern. If large swathes of pension fund capital are being invested in ways which actively undermine beneficiaries' long-term financial interests (as Kay concludes they are) and if fiduciary duties are widely believed to justify or even to require such strategies (as we have found they are), the law is clearly not functioning effectively.

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

As indicated in response to question 1, on the whole we agree with the Commission's conclusions about the circumstances under which trustees are permitted to take ethical issues into account. However, we do not agree that those circumstances are as "limited" in practice as the paper suggests. Nor do we believe that it is necessary or desirable for them to be so limited. We discuss this further below. Many of our comments are also applicable to the question of beneficiaries' quality of life and other non-financial interests, since in both cases the underlying legal principle is the 'tie-break' as expressed in *Harries v. Church Commissioners*.

Although we focus largely on ethical screening because this is the focus of the Commission's discussions on the tie-break, the equation of 'ethical investment' solely with ethical exclusions is outdated. For example, 'best in class' approaches (discussed by the consultation paper in relation to ESG integration) are increasingly common. In addition, as we pointed out in our 2012 survey of UK ethical retail funds,[20] shareholder engagement may be a more appropriate mechanism for acting on the issues members care about. Although some of the issues discussed below still apply, such an approach avoids the potential disadvantages of reducing a fund's investment universe, along with the legal issues this entails. We are somewhat concerned that the identification of 'ethical considerations' with 'screening' encourages trustees to take an overly restrictive approach to ethics, and to assume that the legal issues posed by screening apply to any ethically-motivated activity. As discussed below, this encouragement to major owners of companies to be amoral has significant public policy implications.

<u>The ethical tie-break in practice</u>

We do not agree with the Commission's conclusion that it will be "rare" for the tie-break scenario to arise in practice.

We believe this conclusion stems partly from a mischaracterisation of what the tie-break means in practice for pension funds. Since most pension funds delegate stock selection decisions to their asset managers, most pension fund trustees will never be in the position of making a direct choice between 'A Ltd and B Ltd', and using ethical factors to 'break the tie' in the event that the two companies appear equally attractive financially. Rather, the role of trustees will be to set the general investment policy within which asset managers make stock selection decisions.

There are two ways in which the tie-break could play out in this context. Let us assume that a board of trustees have surveyed their members and identified some widely held ethical concerns, or that they have been approached by a significant number of beneficiaries who feel uncomfortable with certain investments being made by the fund. Trustees might take advice and conclude that making the exclusion will have no material financial impact, and on this basis instruct their asset managers to avoid the stocks in question. Alternatively, if they were not so satisfied, they might instruct their fund managers to avoid the stocks *if* they were able to replace them with equally attractive stocks with similar characteristics (in other words, instruct the fund manager to perform the tie-break exercise themselves – effectively the scenario which Sir Robert Megarry seemed to be envisaging). In either case, the tie-break scenario arises *proactively* rather than *reactively* in contemplation of two financially identical stocks. Or, as Charles Scanlan puts it,

"The development of such a policy will likely involve a more complex process than a straightforward comparison between particular investments... or even than a comparison between specific investment strategies. The focus may be more on constructing a policy which meets the fiduciary standard of prudence in absolute, rather than relative, terms. To that extent, therefore, the 'ethical tie-break' concept, although sound in principle, is an oversimplification."[21]

We also disagree that it will generally not be possible in practice to identify relevant issues due to the inherent subjectivity of ethical concerns. While the Commission is right that "outside affinity

[20] FairPensions, 2012, 'Ethically engaged: A survey of UK ethical retail funds', available online at http://fairpensions.org.uk/sites/default/files/uploaded_files/researchpublications/EthicalFundReportII.pdf

[21] Charles Scanlan (ed.), 2005, Socially Responsible Investment: A Guide for Pension Schemes and Charities, London: Key Haven

groups, it becomes more difficult to achieve consensus on what ethical issues are" (paragraph 10.102), the tie-break scenario precludes the need for such consensus: it is enough for trustees to identify that a significant proportion of beneficiaries share a particular concern, and that this can be accommodated without disadvantaging others. Such a partial consensus is clearly far from impossible to identify, even in large funds with a diverse beneficiary base – still less so for occupational schemes whose members share similar work or other common characteristics.[22]

For example, UK funds which have surveyed their members' ethical views, such as The Pensions Trust and NEST (which surveyed its target demographic as a proxy for the views of future members) have tended to find a remarkable degree of consistency in the issues prioritised. The most widely held concerns were about human rights, labour rights and environmental protection – with the 'sin stocks' traditionally screened out by ethical investment products, such as gambling, alcohol and pornography, coming much further behind.[23] (Interestingly, these are all issues which are difficult to screen for, and which may be more amenable to an engagement-led approach of the type discussed above.)

The feasibility of prudent, financially sound, beneficiary-driven ethical investment policies is demonstrated by many Scandinavian pension funds, where ethical investment is much more generally accepted than in the UK. (One particular example, the Danish fund PKA, is considered at some length in 'The Voice of the Beneficiary'.)[24] From speaking to these funds, we understand that their policies are essentially based on a version of the 'tie-break' principle – i.e. their ethical criteria must not have a negative impact on returns – but this principle is interpreted much less cautiously than either current UK norms or the Commission's characterisation. There is no evidence that these Scandinavian funds deliver poorer financial outcomes than their UK counterparts, or that the acceptance of ethical investment has 'opened the floodgates' to trustee malfeasance or irresistible pressure from vested interests.

<u>The current UK situation</u>

At present, beneficiaries who raise an ethical issue with their fund are usually met with the response that the trustees' fiduciary duties prohibit them from taking ethical issues into account, and the process ends there, before any consideration of tie-breaks or impartiality. This view of the law is at odds with that expressed by the Law Commission. Whilst we understand the Commission's view that trustees should be able to cite fiduciary duties in the face of pressure from "narrow interest groups", we cannot agree that this should extend to beneficiaries themselves who hold genuine moral concerns about the use of their own money. In any case, it does not seem to us that such outside pressure is a widespread problem in practice. Even if it were, the trustees would still be able to invoke fiduciary duties to resist the course of action being urged if they believed that it would be contrary to beneficiaries' interests. This correct application of the law would be preferable to the prevailing incorrect application of the law, which dismisses all ethical concerns alike on the basis that they are improper considerations for a fiduciary investor. We cannot see any reason why this misunderstanding (or misuse) of fiduciary duty should be actively encouraged.

<u>The case for a broader approach</u>

We appreciate the Commission's concern to avoid diluting trustees' focus on providing their

[22] This is discussed more fully in 'The Voice of the Beneficiary'

[23] This is considered fully in 'Our Money Our Business' and the accompanying best practice guide (ShareAction, 2013, 'Engaging savers with stewardship and responsible investment: Best practice guide for pension schemes and asset managers', available at http://www.shareaction.org/sites/default/files/uploaded_files/investorresources/BestPracticeGuide.pdf)

[24] Ref voice of beneficiary

beneficiaries with a pension, and agree that this is "not an easy task" (paragraph 10.25). However, in our view there are equal and opposite dangers in encouraging an overly rigid fixation on financial returns. It is not always possible in practice to make as clear a distinction as the paper does between financially material ESG issues and purely ethical issues. This assumes that the financial impact of individual ESG issues can reliably be known and measured, which is not always the case. If trustees are given a strong message that it is legally risky to act on ethical issues for their own sake, they may conclude that it is safer not to act on ESG issues at all except where the financial case for doing so is clear and immediate. By stressing the duty to act in line with the purpose of the trust over the duty to take relevant considerations into account, the Commission is effectively making a judgement that the risk of allowing pension funds to be 'too ethical' is greater than the risk of encouraging pension funds to ignore potentially material risks. We disagree.

Indeed, it is now widely held that the 2008 financial crisis was in part a crisis of ethics within the banking system – prompting politicians across the political spectrum to suggest that capitalism has lost its 'moral compass' to the detriment of financial and economic stability. Of course we agree with the Commission that the duty of fiduciary investors is to their beneficiaries and "not to improve the world in some general sense" (paragraph x). We have never argued otherwise. However, it is far from self-evident that it is to the benefit of beneficiaries – either financially or as members of society – to encourage fiduciaries to behave amorally. In our view it is a public policy problem if a collection of individual savers, all of whom are members of society with moral values, become dehumanised and stripped of any moral dimension when their savings are pooled and invested by a pension fund.

Indeed, as discussed in 'Protecting our Best Interests',[25] promoting ethical investment has been an explicit policy objective of recent interventions such as the 2000 disclosure requirement on 'SEE' policies. Successive governments have taken the view that the law does allow for financially prudent ethical investment strategies, but have stopped short of explicitly clarifying this through legislation. In our view, the fact that this question continues to be debated creates a strong case for such clarification.

As indicated above, we are particularly concerned here with the impact of this thinking on the behaviour of listed companies who ultimately answer to their shareholders, rather than with the possibilities for ethically screened portfolios. If the default position is that major fiduciary investors should not concern themselves with ethics, this imperative is inevitably transmitted along the investment chain to the companies in which they invest. The view that it is not for investors to care about morality is inextricably linked to the view that "the social responsibility of business is to increase its profits". This in turn is inextricably linked to the short-term shareholder-value mentality which contributed to the banking crisis. As Lynn Stout puts it:

"Shareholder value thinking looks at the world from the perspective of a Platonic investor whose only asset is equity shares in one firm (say, BP) and whose only purpose and desire in life is to raise today's price for BP's shares by any means possible. But this Platonic shareholder does not exist. Real human beings own BP's shares."[26]

If fiduciary investors are told that they must only consider ethics 'in limited circumstances', they are effectively being told that they must behave like 'Platonic investors' rather than institutions

[25] On pages 86-87

[26] Lynn Stout, 2012, 'The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations and the Public'. Berrett-Koehler Publishers

which hold investments on behalf of 'real human beings'. Of course, to some extent the adoption of 'universal owner' thinking could help to alleviate this problem. But our concern is that, if the Commission endorses a cautious approach to the role of 'universal owner' thinking or quality of life considerations in practice, and a hostile approach to the role of beneficiaries' ethics, the duty to protect beneficiaries' financial interests inexorably narrows to a duty to maximise short-term returns. After all, this is perceived as the most reliable metric for measuring beneficiaries' financial interests, and trustees have been given a clear message that they may be breaching their duties if they cannot justify their decisions on financial grounds.

To be clear, we are not suggesting that fiduciary investors should be *obliged* to be 'ethical' investors, or that investors should pursue moral causes to the detriment of their beneficiaries' financial interests. We agree with the Commission's view of the law, but believe both that this allows a greater role for ethics in practice than the Commission suggests, and that it would be a mistake to play down this role in the name of protecting beneficiaries' interests. In our view, the threat to returns from opening the door too wide to ethical investment is largely illusory. Strategies focussed on the aggressive maximisation of short-term returns pose a much bigger and more immediate threat to returns in the long run (see also our response to question 12) – indeed, this is the reason for the present review – and a more flexible approach to the role of ethics could be part of the solution to these problems.

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

We agree with the Commission's interpretation that "the courts do not require a portfolio to be diversified to the fullest extent possible. Instead trustees should avoid excessive reliance on any particular asset, and the strategy as a whole should not exclude too much of the market. It is a question of degree in each case." (paragraph 10.89) This is the common-sense interpretation of the investment regulations. We also welcome the Commission's recognition that "increasing diversification is not necessarily an unmitigated good" (paragraph 10.88) and that trustees may have good reasons to prefer a less diversified portfolio.

We suspect that the duty to diversify is generally interpreted in a more expansive way than is justified by the evidence, which suggests that the benefits of diversification tail off dramatically above around 30 stocks[27] - well below the thousands held by most UK pension funds. Clearly, this has at least as much to do with conventional investment wisdom as with interpretations of the law. However, the 'signals' sent by the investment regulations, combined with trustees' fear of incurring liability if they depart from the safety of the herd, almost certainly encourage this mentality.

One possible response would be to 'balance' the duty to diversify with a duty for the trustees to satisfy themselves that either they or their fund managers are able to adequately monitor the risks associated with the underlying investments held. However we offer this as a speculative suggestion only: it does not form part of our proposal for statutory clarification.

[27] Elton E.J. and Gruber M.J. , 1977. "Risk Reduction and Portfolio Size: An Analytic Solution." *Journal of Business,* 50: 415-37, Chicago

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

As discussed above in response to question 7, prevailing interpretations of the law may encourage trustees to neglect certain risk factors which are not well captured by short-term financial data or conventional investment models. The frequent invocation of the mantra 'we have a duty to maximise returns' (usually not preceded by the phrase 'risk-adjusted') reflects this bias. This is a sharp contrast from the pre- and early-twentieth century notion of prudence as 'safe' investment, embodied by the 'closed list' system.[28] While we would not suggest a return to that interpretation, which is undoubtedly outdated, it is possible the pendulum has swung too far the other way.

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

We are unclear exactly what is meant by this question. However, we do think there are significant systemic risks which pension funds are generally not managing effectively, which prevailing interpretations of the law treat as extraneous matters, and which have potentially disastrous implications for pension outcomes at the system level. As the consultation paper notes, quoting from our response to the stakeholder paper, the banking crisis is a clear example of a systemic risk which, far from being managed or reduced by major fiduciary investors, was actively fuelled by prevailing investment mentalities obsessed with short-term financial returns. We understand that only one major UK asset manager voted against the takeover of ABN-AMRO by RBS; only one other abstained. Of course, there are many reasons for this, but the pressure on fund managers from institutional clients to maximise short-term returns, and the lack of positive pressure from those clients for the management of longer-term risks, was surely a factor.

In our view, climate change represents the next major systemic risk to pension savers. On the one hand, various recent studies have warned of the risk of a 'carbon bubble', whereby fossil fuel stocks are valued based on reserves which cannot be burned if international climate targets are to be met, and will inevitably plummet in value if concerted political action is taken to meet these targets.[29] The consequences of such a fall would be catastrophic for pension funds, since fossil fuels are heavily over-represented on the indices against which they benchmark. On the other hand, if this scenario does not come to pass and climate change goes unmitigated, the economic impacts will be severe and unpredictable – for example, greater food and fuel price volatility and the impact of extreme weather events. Our recent report, 'Green Light: Resilient portfolios in an uncertain world', explores these risks and the practical steps pension funds could take to mitigate the impact on their investments.[30]

To be clear, this is not the same as saying that pension funds have a responsibility to 'stop climate change'. However, many of the steps which funds might take to protect their portfolios (which include, for example, engaging with fossil fuel companies to discourage them from using shareholder capital for risky exploration, making use of carbon tilted indices, and seeking out investment opportunities in the green growth industries of the future) would have the additional benefit of contributing to this objective, thereby safeguarding beneficiaries' future quality of life.

[28] For a full discussion of this see Chapter 1 of Protecting our Best Interests

[29] See for example Carbon Tracker & The Grantham Institute. 2013. 'Unburnable Carbon 2013: Wasted Capital and Stranded Assets.'http://carbontracker.live.kiln.it/Unburnable-Carbon-2-Web-Version.pdf

[30] Report available at http://www.shareaction.org/sites/default/files/uploaded_files/investorresources/Green-Light-Report-web.pdf

This more nuanced approach to the case for fiduciary investors to manage climate risk is essentially that adopted by the market-leading Environment Agency Pension Fund.[31] Despite this, as noted in our response to question 3, numerous pension funds responded to recent member emails on this topic by saying their fiduciary duties precluded them from thinking about climate change.

The consultation paper notes that "no court would find pension fund trustees liable for having failed to prevent the banking crisis or global warming" (paragraph 10.77). We do not disagree with this and are not proposing to change this position. However, in some ways this is beside the point. In retrospect, 'preventing the banking crisis' would probably have had the single biggest impact on financial outcomes for people saving into a pension today. Yet prevailing investment strategies, and prevailing interpretations of fiduciary duty, exacerbated rather than mitigated the problem. In decades to come, we may well say the same about climate change. In a similar vein, recent work by the Actuarial Profession modelling the financial impacts of natural resource constraints – a factor which is usually ignored in actuarial analyses – found that in a worst case scenario, their model defined contribution scheme reduced its income replacement ratio by half, while the model defined benefit scheme became insolvent.[32] Explicitly authorising fiduciary investors to take a more flexible and enlightened approach to these problems, far from posing a threat to returns, is a step which is urgently needed in order to safeguard returns for the next generation of savers.

Question 12/13 Overall, do consultees think that the legal obligations on trustees are conducive to investment strategies in the best interests of the ultimate beneficiaries? If not, what specifically needs to be changed?

In answering these questions, we refer to the equivalent passage of the terms of reference, which refers to trustees' legal obligations "as established in law or as applied in practice". We had understood that this distinction was vital to the remit of this review, since the view shared by ourselves, Professor Kay and the government was that the underlying legal principles were sound but widely misinterpreted (see our response to question 7).

In our view, fiduciary obligations as interpreted in practice are not conducive to investment strategies in the best interests of beneficiaries, for all the reasons given in our previous publications and submissions, and in response to previous questions. Briefly, the duty to protect beneficiaries' financial interests is too often equated to a crude "duty to maximise returns" which in turn is operationalised by focussing on short-term financial performance of investments. As Kay observed, there is good evidence that this mentality may actively undermine beneficiaries' long-term financial interests, both at an individual fund level and at a system level.

The reality is more conducive to beneficiaries' best interests, though there are still some problems:

1) If the Commission is right that there is no duty of **stewardship** where ownership is widely dispersed, and if we accept the premise that good oversight of companies is likely to lead to better performance, then there is a clear public policy problem with the law as it stands –

[31] See Environment Agency. 2012. 'Active Pension Fund: Responsible Investment Review 2012.' http://www.environment-agency.gov.uk/static/documents/Business/Responsible_Investment_Review.pdf

[32] Jones et al, 2013, 'Resource constraints: sharing a finite world. Implications of Limits to Growth for the Actuarial Profession.' http://www.actuaries.org.uk/research-and-resources/documents/research-report-resource-constraints-sharing-finite-world-implicati

namely that the law essentially enshrines and endorses the concept of the 'ownerless corporation'. This cannot be in the long-term interests of beneficiaries taken as a whole. In particular, the Commission's characterisation of the law suggests that investors are legally obliged to be 'free-riders', i.e. that stewardship activities which benefit the system as a whole should be resourced and undertaken solely by very large market participants with significant stakes, and can safely be ignored by others. If this is indeed the legal position, then there is a need for the law to be changed.

2) On a related note, we disagree with the Commission's implicit conclusion that the "**duty to gazump**" is consistent with investment strategies in the best interests of beneficiaries, and that where **collective action problems** limit the incentives for investors to act alone towards ends which would collectively benefit their beneficiaries, they should not so act. Although we agree with the Commission's analysis of the "remoteness problem" in *Cowan v. Scargill* and the "duty to gazump" in *Buttle v. Saunders,* in our view this risks perpetuating a "lowest common denominator" approach to fiduciary duties which is seriously problematic when applied to large market participants.[33] In this respect, the collective action problem is indeed a legal problem as well as a practical one (paragraph 10.75). Indeed, it is precisely the role of the law to step in and correct collective action problems where they are resulting in suboptimal outcomes at the system level. At present, the law of fiduciary duties does the reverse.

   We have therefore suggested that fiduciary investors should be authorised to adopt standards of conduct which they believe it is in their beneficiaries' interests for market participants to adopt, regardless of the behaviour of other market participants.[34] This would be in line with John Kay's principle that fiduciaries should not be required by law to "depart from generally prevailing standards of decent behaviour". Our proposal differs insofar as it sets this explicitly in the context of what will serve beneficiaries' interests, rather than "improve the world in some general sense".

3) As discussed in response to questions 1, 2, 7 and 8, we are concerned that the combination of a low bar for the duty to take relevant factors into account and a high bar for the duty to exercise powers for a proper purpose may not be conducive to investment strategies in beneficiaries' best interests. For example, as we argued in response to question 8, while the financial impact of ESG issues in general is well-evidenced, it is not always possible to identify and measure the impact of individual issues or of particular activities undertaken to manage them, such as voting and engagement. If investors believe that they can only justify the use of their resources on activities which have a clear and immediate financial benefit, and that it is better to 'err on the side of caution' in borderline cases to avoid being exposed to liability, they are likely to miss or neglect material issues and adopt strategies which are suboptimal for their beneficiaries. Paradoxically, fiduciaries may need to be authorised to have regard to beneficiaries' non-financial interests in order to most effectively equip them to protect beneficiaries' financial interests.

   In this context, it is worth noting that the conventional approach of maximising short-term returns while ignoring other factors has singularly failed to produce good financial outcomes for pension savers over recent decades: from 2000-2009, the average annual real

[33] See 'Protecting our Best Interests' for further discussion of this
[34] See 'The Enlightened Shareholder' for further discussion of this

returns achieved by UK pension funds were just 1.1%.[35] Likewise, policymakers concerned to reduce the costs of pension provision for savers are rightly far more concerned about the real problem of excessive fees and charges – perpetuated in part by a lack of fiduciary oversight down the investment chain – than the illusory potential problem of pension funds incurring undue costs from stewardship or ESG integration. Of course, as indicated in response to question 8, we understand the Commission's concern to avoid diluting pension funds' focus on achieving financial returns. Our proposed statutory clarification would reaffirm the primacy of this objective whilst authorising fiduciaries to consider a wider range of factors to the extent that this objective was not compromised. The difference between this and the Commission's statement of the current law is one of emphasis rather than substance; the aim would be to **promote flexibility and the exercise of discretion and judgement on the part of trustees**, rather than blind adherence to failed models.

4) As suggested in 'The Voice of the Beneficiary', the rule in *re Londonderry* [Rule],[36] whereby fiduciaries are not obliged to provide an account of their decision-making to their beneficiaries, is an artefact of private trust law which has been inappropriately carried over into pensions law and should be explicitly overridden. Pension savers who have effectively paid for their benefits should have the right to an account of decisions made on their behalf.[37]

   There is, none the less, one facet of pension scheme administration where we think that the *Londonderry* principle could still properly apply, namely, the exercise of trustees' discretion over the payment of lump sum (or other) benefits payable on the death of an individual member. Here, the position is very similar to that of a private family trust. For example, the scheme trustees will often have received a written expression of the deceased member's wishes as to who should benefit, which closely equates to the settlor's letter of wishes that is common in family discretionary trusts.

   Indeed, we would argue that the suggested retention of the *Londonderry* rule in this particular is based on the same principle as its suggested general abolition in relation to pension schemes: the proper recognition of the **property rights** of the scheme members, who have the dual character of beneficiary and **settlor.** Given the collective nature and/or collective investment arrangements of most pension schemes, the recognition of these property rights will normally have to take a collective form, such as consultation and accountability by trustees (and their delegates) in relation to their investment (and other) activities. In the case of the disposal of individual benefits, however, a rule evolved to suit the particular needs of private trusts may still be appropriate.

[35] See Paul Woolley, 'Why are financial markets so inefficient and exploitative – and a suggested remedy', in LSE, 2010, 'The Future of Finance', p135

[36] *Re Londonderry's Settlement* [1965] Ch 918, CA
[37] See 'The Voice of the Beneficiary' for further discussion on this

FIDUCIARY-TYPE DUTIES IN CONTRACT-BASED PENSION SCHEMES

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?

Yes. As argued in our 2012 publication 'Whose Duty? Ensuring effective stewardship in contract-based pensions',[38] we believe there is a serious imbalance between the duties on trust- and contract-based pension providers which could undermine the success of auto-enrolment. In our view there is a need for regulatory or (ideally) legislative intervention to correct this imbalance and ensure that savers in contract-based pensions are adequately protected.

Indeed, as we have previously argued, it is increasingly clear that the assumptions underlying the regulation of contract-based pensions are fundamentally at odds with the assumptions underlying auto-enrolment. Contract-based regulation is built on the principles of informed consent and consumer choice. Auto-enrolment is built on the principle of inertia. It is specifically designed to create a new cadre of essentially passive pension savers who will neither understand nor engage with the fund choices made on their behalf. In our view, this is a prime example of the need for fiduciary oversight.

Of course, as we argue in 'Our Money, Our Business', this situation should not be regarded as inevitable or desirable: anything which encourages more consumers to engage with their money is likely to make the market function more efficiently. But we entirely accept that such engagement will never be undertaken by all or even the majority of consumers. While savers should be guaranteed the *right* to engage with their money, the legal and regulatory framework must adequately protect those who do not engage. As we understand it, this is essentially the approach of the Australian regime.[39]

More generally, in our view there is a case for harmonising the fragmented UK regulatory regime, the problems of which have been well-rehearsed by the National Audit Office,[40] the DWP Select Committee[41] and the consultation paper itself (at paragraphs 13.61 – 13.68). As the paper notes, the single regulatory regime in Australia appears to function well. Although the government has rejected the idea of a single regulator, we continue to believe that the dual regulatory structure poses problems which need to be addressed – if not by the creation of a new single regulator, then at least by enhancing The Pensions Regulator's powers and duties in respect of contract-based schemes.

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[38] FairPensions, 2012, 'Whose Duty? Ensuring effective stewardship in contract-based pension schemes', available at http://fairpensions.org.uk/sites/default/files/uploaded_files/policy/WhoseDutyFinal.pdf

[39] Discussed in 'Whose Duty?'

[40] National Audit Office, 2012, 'Regulating defined contribution pension schemes'

[41] DWP Select Committee, 2013, 'Improving governance and best practice in workplace pensions'

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?

Yes. As we argued in 'Whose Duty?', based on empirical evidence from our 2012 survey of UK insurance companies and on input from experts at a 2012 roundtable,[42] the absence of ongoing monitoring of funds is at the heart of the so-called 'governance gap' in contract-based pension funds. We found that, while insurance companies may monitor their in-house funds (which of course poses obvious conflicts of interest in its own right), they do not see it as part of their duty to monitor all the funds on their platform, taking the view that this responsibility rests with the individual saver who has chosen the fund. In the context of auto-enrolment, this is plainly not a feasible assumption. In addition, it is inconsistent with the duties of trustees of defined contribution pension funds, where the fact that savers are given a choice of fund does not alter the trustees' fiduciary responsibility to oversee the funds offered on behalf of members.

However, the contract-based framework poses inherent problems in this respect, which arguably reflect its deeper inappropriateness to the mechanics of auto-enrolment. For example, if a provider reviewed one of the funds on its platform and concluded that it was no longer suitable, it is not clear how they could act on this decision by moving members' money unless they first obtained the consent of all the savers affected. It is in the nature of auto-enrolment that this active consent would be very unlikely to be granted by all savers, particularly in respect of funds which are being offered as default funds. Presumably, this problem could potentially be dealt with through express contractual terms, but this does not resolve the problem for the many savers who have already been auto-enrolled. In addition, if providers are to have responsibility for reviewing funds offered to auto-enrolled savers, it is vital that those making these decisions are subject to strict general duties to put the interests of savers first and avoid conflicts of interest.

If duties to review suitability are to be imposed, it might be logical for these to replicate the requirements on trustees to review their Statements of Investment Principles, which currently specify that this must take place every three years. However, it is worth noting that most trust-based funds monitor their fund manager (or, in the case of defined contribution funds, the fund options they offer) much more frequently than this. In our view, the most important imbalance between trust- and contract-based governance is not simply the absence of a regular, one-off review of fund suitability, but the more continuous oversight of fund managers and investment strategies which a trustee board might be expected to undertake.

Introducing a specific new regulatory requirement to conduct suitability reviews is unlikely to fully resolve this problem, and could degenerate into a 'tick-box' exercise if the underlying governance problems affecting contract-based provision are not resolved. Indeed, it is precisely this tick-box mentality which John Kay wished to avoid when he suggested that the overarching ethic of care required by fiduciary standards was an important complement to detailed regulatory rules which could be gamed. In addition, the Commission should be mindful of the need to avoid unintended consequences. For example, three-yearly reviews of fund suitability could create pressures on fund managers to focus on short-term returns in the run-up to a review, mirroring the perverse incentives created by triennial valuations for defined benefit schemes.

[42] FairPensions, 2012, 'The Stewardship Lottery: The governance gap in contract-based pensions', http://www.shareaction.org/sites/default/files/uploaded_files/researchpublications/StewardshipLottery.pdf

For these reasons, we would favour a general duty on contract-based providers to monitor the suitability of funds offered on an ongoing basis, combined with stronger duties to prioritise the best interests of savers, rather than a specific duty to conduct suitability reviews of a set frequency.

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

Yes. We agree with the Commission that "there are many difficult questions about how these committees will work" (paragraph 14.42) and believe it is problematic that they "will not have the same powers and responsibilities as trustees" (paragraph 2.64). Without significant steps to strengthen the currently agreed framework, the impact these committees will have is highly uncertain. In our view, members of Independent Governance Committees (IGCs) must have not only explicit legal duties to act in scheme members' best interests, but also explicit *powers* to make and implement decisions about the scheme. We cannot see how a merely advisory committee is adequate to address the fundamental problems of governance and accountability identified by the OFT and the Law Commission. Making IGCs accountable to the boards of pension providers, without addressing any of the conflicts faced by these providers, or clarifying that decisions about schemes must prioritise the interests of policyholders over those of shareholders, does little or nothing to resolve the gap between trust- and contract-based governance.[43] Moreover, as we argue in Whose Duty?, previous experience with bodies such as with-profits committees suggests that such advisory bodies are frequently sidelined within firms' decision-making structures.

If it is not deemed viable to require contract-based pension schemes to be run by independent boards with a duty to protect savers' interests, then there is a strong case for saying that policymakers should promote (or even require) the use of large, well-run trust-based schemes for auto-enrolment, as the paper notes is the case in Australia.

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

We have no strong view on this question, but our tentative response is that this would be sensible. Although this would not mirror the position for trustees of trust-based schemes, in practice many trust-based schemes use corporate trustees to protect their trustees from liability. Moreover, given the size and complexity of the firms in question, the potential liabilities faced by members of IGCs could presumably be much greater than for the average trust-based scheme.

[43] We discuss these issues further in our briefing on the OFT report and in our response to the OFT's consultation on its provisional decision not to refer the industry to the Competition Commission. Both are available on our website at http://www.shareaction.org/policy.

FIDUCIARY DUTIES IN THE REST OF THE INVESTMENT CHAIN

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

The consultation paper notes that the current legal position is not that which Professor Kay advocated, but does not suggest clear remedies for this. We agree that the courts are not necessarily the best vehicle for policing market conduct and that FCA rules may provide a better solution to some of the problems identified. However, like John Kay, we think that fiduciary duties provide a useful (and helpfully flexible) backstop where detailed regulatory box-ticking has failed to deliver adequate standards of behaviour or to inculcate the appropriate ethic of care towards clients. On this basis, we continue to believe that there may be a case for statutory change, which – while not amounting to a wholesale codification of the general law of fiduciary duties – would clarify and strengthen the duties owed by investment intermediaries to their clients.

We do not dispute the Commission's conclusion that investment intermediaries are unlikely to owe duties to ultimate beneficiaries which 'leapfrog' their relationship with their immediate clients. Our concern is with the nature of the relationship between investment intermediaries and institutional clients. In our view, the appropriate way to think about fiduciary relationships in this context is as a series of links in a chain, with duties owed in each case to the next party in the chain. However, like John Kay, we suggest that this chain is "only as strong as its weakest link" (paragraph 11.8). If asset managers owe fiduciary duties neither to their immediate clients nor to the ultimate beneficiaries, and are not held to equivalent standards of care by statute or regulations, this creates a potential vacuum of fiduciary responsibility which is problematic given the increasing trend towards delegation by asset owners.

In our view, the approach taken by the courts to these questions creates public policy problems, and it would be helpful for the Commission to make clearer and more specific recommendations for remedying these. For example, the Commission notes that the courts have in recent years been reluctant to impose fiduciary obligations on the agents of sophisticated investors which go beyond the terms of their contract or regulatory rules. However, it also notes that "'sophistication' is not a defined term" (para 11.58). Although the consultation paper does not explore the question of whether all institutional clients would be treated by the courts as 'sophisticated', it does consider the related question of client categorisation under MiFID and FCA rules, noting that "there could be important implications for treatment of clients by intermediaries if, for example, a small five member pension scheme is treated as a per se professional client" (para 8.46).

As the Commission observes, "where small pension schemes lack internal staff, trustees tend to be highly dependent on intermediaries" (para 2.58), and "small trusts are unlikely to have market power to insist that terms excluding or heavily limiting the agents' duties are removed from agency agreements" (para 7.38). In our view this problem needs further consideration, as it points to a potential vacuum of fiduciary responsibility where small, poorly-resourced trust-based schemes are concerned. Although we agree that consolidation is desirable, this will inevitably take time and cannot be the sole policy response to this problem. One possible intervention would be to amend FCA rules to extend protection against the contractual exclusion of fiduciary obligations to professional clients, or, at the very least, to provide guidance on whether and in what circumstances trust-based pension funds are considered to be per se professional clients. Given that the courts look to regulatory rules when interpreting the extent of agents' duties, there may also be a need to strengthen FCA rules and enforcement in certain specific areas – most notably with regards to the avoidance and management of conflicts of interest.

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

Yes. It is clearly an anomaly that advice on specific trading decisions is regulated but advice on 'generic' investment strategy is not, given that advice of the latter kind is significantly more critical to the success of a fund in achieving its objectives. As the Commission notes, investment consultants are extremely powerful players in the investment chain, whose activities have a huge impact on outcomes for beneficiaries. Due to the concentration of the market, the activities of individual consulting firms are not only highly significant for individual pension funds but are systemically important to outcomes for pension savers as a whole.

Consultants have a direct commercial incentive to advise funds towards complexity, which may help to explain the growing complexity of pension funds' investments strategies. This in turn further reduces the scope for effective fiduciary oversight of investment strategies by trustees and increases their reliance on professional investment agents. As we noted in 'Protecting our Best Interests', the average externally managed pension fund now has nine mandates, compared to just three a decade ago.[44] As the Commission indicates in Chapter 3, the role of consultants in the trend towards liability driven investment strategies also requires further examination.

In addition, as we noted in our response to the stakeholder paper, where trustees are legally obliged to take advice but consultants have no clear responsibilities in respect of that advice, it is not clear who holds responsibility for ensuring that potentially material risk factors are considered. This potentially creates a vacuum whereby trustees rely on consultants to tell them what issues they should take into account, and consultants will not proactively raise certain issues with trustees where they have not explicitly been asked to address them.[45] The growing popularity of 'fiduciary management' makes this question all the more urgent and is in our view potentially cause for concern.

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

Since we have not conducted research on the specific legal issue raised by the Commission, we are reluctant to express a view on this issue. However, as observed by the Kay Review and discussed in Chapter 4 of our recent report 'Our Money, Our Business', the rise of nominee holdings clearly has significant implications for the functioning of equity markets, and puts custodians in a critical position as regards investment and stewardship activity. In our view there is a need for further examination of this area to ensure that (a) the regulation of custodians is adequate, and (b) those who hold the economic interest in a share have adequate rights to instruct as to the exercise of rights attaching to it, including voting rights.

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

In our response to the Kay Review's call for evidence we suggested that the prevailing practice of allowing investment agents to retain fees from stock lending could pose problems and should be reviewed. This remains our view. However, as we have not conducted specific research in this area, we have no detailed comments to make on this issue.

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[44] The WM Company, 2010, cited in Lane Clark & Peacock, 2011, Investment Management Fees Survey, p1

[45] See page 3 of our response to the stakeholder paper.