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Law Commission  
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Dear Dr Akinbami

### **Fiduciary Duties of Investment Intermediaries**

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the Law Commission's Consultation Paper (CP) 'Fiduciary Duties of Investment Intermediaries'. This response has been compiled by members of the IFoA who work across a range of disciplines. The IFoA would encourage the Law Commission to consider the aggregate effect of its recommendations, not just from the perspective of individual schemes and beneficiaries, but whether the overall outcome is desirable for society as a whole.

The IFoA has limited the response only to questions where a response falls within our expertise.

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

Some beneficiaries may have no immediate economic interest in the investment strategy followed by a pension scheme. To the extent that the employer and the Pension Protection Fund stand behind a scheme, and a member is high in the priority order for a scheme, their benefits are fixed and unaffected by asset performance. The 'best interests' of a diverse group of beneficiaries can thus be very difficult to determine. In practice, this is therefore subject to legal advice, based upon precedent.

Our understanding is that current case law generally provides that the best interests of the beneficiaries are served by trustees acting in the beneficiaries' best financial interest. The IFoA supports the idea that 'best interests' should be interpreted more broadly than just being the short-term financial return of the fund, as suggested in the consultation paper.

We note (section 10.10) that one example of how the law has evolved is to incorporate ESG considerations. Further evolution would also be beneficial were it to allow the consideration of beneficiaries' best interests from a longer term, more holistic perspective, having regard to global social, political and economic factors. The implications of resource limitations and climate change for example, may not emerge for many years but may have profound implications for corporate strategies in the meantime.

#### **6. Do consultees agree that the law permits a sufficient diversity of strategies?**

In our view, the law permits a great diversity of strategies. There is potentially some timidity on the part of trustees, or their advisers, to leaving the safety of the "investor herd". One of the factors in such behaviour would be a fear, perhaps misplaced, that their decisions would be tested against those of their peers in a Court of Law. Nonetheless, it is clear from our experience that pension

schemes employ a broad range of strategies. Competitive and marketing pressures have been successful in encouraging the development and adoption of new strategies.

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

Although the duty to invest in best interests could reasonably be interpreted by a trustee board in terms of long term, rather than short term, returns, this may be difficult to achieve for a number of reasons. Primarily, measurement of success is often much easier in the short term. Trustees can face understandable pressure to replace portfolio managers on the basis of poor short term performance and would expect their investment consultants to catch problems early. Managers willing to face short term risk in return for long term gain are, therefore, likely to see mandates terminated.

In our view, trust is an important component of the ability to operate on a longer term basis. A portfolio manager, who has confidence in the relationship with a trustee board, should also be more confident to focus on long term performance. It could be that trust is more difficult to maintain in an extended investment chain, but relatively easier for funds with sufficient scale to employ 'in-house' portfolio management.

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

The broader interest, not just of beneficiaries, but of society as a whole, could be a factor that trustees and investors are able to take into account. It appears odd that ethical behaviour could be regarded as illegal.

As shareholders, the trustees could have freedom to invest only in company management that exercises stewardship with integrity and in accordance with the law in all the jurisdictions in which they operate. Other ethical issues need to be considered from a long term financial perspective, including consumer pressures and governmental reactions. We would encourage policymakers to consider whether the law in this area is too narrow, or perceived to be too narrow, so that these broader issues may be taken into account.

Further encouragement for longer-term thinking should have regard to sustainable investment strategies; these could include ethical considerations, which may provide longer term returns.

**9. Does the law encourage excessive diversification?**

Diversification is an appropriate consideration for trustees, but excessive diversification is not encouraged by the law in our view. Studies have shown that sufficient diversification can possibly be obtained with a smaller number of investments than is commonly found. Such an approach may facilitate more long term involvement with investments.

The lack of guidance for trustees in the exercise of their investment decisions in relation to, for example, ethical investments or sustainability in their investment portfolio, does not necessarily encourage excessive diversification, but may encourage inappropriate diversification.

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

The consultation notes the move towards Liability Driven Investments (LDI). In our experience, the risks of such strategies are carefully explained, well understood and generally well managed. Some specific examples of systemic risks that arise from trustees' investment strategies are:

- Resource and environment issues that pose systemic risks across all sectors of the economy, not just those sectors which directly own, or operate, assets that are at risk of "stranding". There is scope for a broader discussion of these risks, a discussion that should involve trustees.
- Procyclical investment strategies that appear to be encouraged to some extent by mark-to-market accounting, and which would tend to increase as pension regulation moves closer to insurance/banking regulation.
- The tendency of trustees' investment strategies to 'herd' towards similar investment solutions, whether by asset class or investment structure, which may not lead to optimal outcomes for beneficiaries.

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

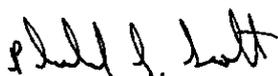
The consultation expresses concerns over the conflicts of interest that can be faced by investment advisers. These concerns are legitimate in our view. A review may be helpful to clarify whether it is appropriate for a provider of investment services also to provide independent advice. In view of the combinations of services that some firms now offer, it may also be worthwhile to consider whether regulatory regimes should apply equally to both investment managers and investment consultants.

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

We note that it has been proposed that all stock lending revenue be 'disclosed and rebated to investors'. We support transparency in investment markets - revenue disclosure should be required as a matter of course. However, we are not convinced that a full rebate is the best solution - revenue sharing is a common and in our view reasonable approach. The commercial terms are arguably best left to market participants rather than being subject to regulation, unless there is evidence of market failure, which does not appear to be the case.

Should you want to discuss any of the points raised please contact Philip Daggart, Policy Manager ([philip.daggart@actuaries.org.uk](mailto:philip.daggart@actuaries.org.uk) or 0131 240 1319) in the first instance.

Yours sincerely



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