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BRIEFING

Pension fund investment

An overview of legal issues for trustees
Employment, pensions and benefits: briefing 111

Summary

This briefing looks at the legal issues for trustees when considering investment of a pension fund. It considers requirements imposed by the trust deed and by legislation (both current and proposed); trustees' fiduciary duties; investment of money purchase assets and the legal issues relating to investment management agreements.

Pension funds together hold a large proportion of the wealth and savings of the country. One of the most important duties of the trustees of a pension plan is to invest and look after the assets.

This briefing looks at the legal issues for pension scheme trustees when considering investment of the pension fund.

- What does the trust deed say?
- What does the legislation say?
- What are the trustees' fiduciary duties?
- What about money purchase assets?

What does the trust deed say?

The trustees need to consider their investment powers under the trust deed and rules. Trust deeds generally give a wide power of investment – this is reinforced by a general power to make investments which is implied under section 34 of the Pensions Act 1995 (see below).

Trust deeds can also contain express limitations, however, for example on all investment in an employer or on loans to members.

Unauthorised investments

If restrictions in a trust deed are present they must be complied with (or the provision suitably amended). If not, any investment contrary to the restriction will be a breach of trust and the trustees will be liable for any losses that result (but will not be able to keep any gains – even offsetting any gains against losses is difficult). This liability will apply even if the investment looked to be a suitable one otherwise. It will also apply even if the scheme includes an exoneration clause (see s33, Pensions Act 1995 – mentioned below).

The decision-making powers under the trust deed must also be checked.

- Is delegation of investment decisions (eg to a fund manager) allowed? There is now a statutory power in section 34(2) of the Pensions Act 1995.
- How can the trustees act – eg by a majority?
- Does the investment power allow investment in general products – eg including options, partnerships, land, derivatives etc?

What does the legislation say?

Investment issues are obviously important, so there has been a fair amount of legislation specifically on this for pension trustees. Unfortunately, it is messy and almost nonsensical in a number of areas, but the government shows no sign of seeking to make it any more intelligible.

Financial Services and Markets Act 2000 (FSMA)

The financial services regime would often not apply to pension trustees (because they would be able to say that they are not acting in the course of a business and there are a number of exemptions for trustees in any event).

In view of this, the legislation contains a specific provision for pension trustees: an authorised person must make 'day-to-day or routine' investment management decisions. This means that either the trustees must be authorised or they must delegate these decisions to an authorised person (eg an authorised fund manager), retaining only strategic decisions (eg broad asset allocation).

This requirement was previously in the Financial Services Act 1986 – see our briefing no. 68, *Pensions and the new financial services regime* (March 2002). Breach of this provision will mean that the trustees should obtain authorisation under FSMA. Failure to do this is a criminal offence.

The government is consulting on proposals partially to relax this limitation – to remove the 'routine' limb of the provision (which was added in 2001).

Pensions Act 1995

This Act also contains a number of provisions dealing with investment issues.

Fund manager (s47(2) Pensions Act 1995)
Trustees must appoint a fund manager in relation to investments (as defined in the FSMA). Arguably this applies (bizarrely) even if the investment is in a pooled product (such as an insurance policy or a unit trust) run by an authorised person under the FSMA. This is one of the more unintelligible provisions.

Appointment issues (s47(3) Pensions Act 1995)
Trustees cannot rely on fund managers or asset custodians unless they have appointed them properly. Regulations set out the manner of appointment (eg must be in writing, must include provisions on dealing with conflicts etc).

Exonerations not effective (s33 Pensions Act 1995)
Trustees cannot exclude or restrict any liability for breach of an obligation under any rule of law to take care or exercise skill in the performance of any investment functions. This is an important issue for trustees. It is one reason why trustee insurance can be valuable. It is arguable that it operates to cancel even indemnities from an employer (on the basis that the employer is owed duties by the trustees in relation to investment matters – see below). Note that some assistance is given to trustees by the later provisions in section 34 (see below).

Trustees not liable if act reasonably (s34(4) and 34(6) Pensions Act 1995)
Trustees are not liable if they take reasonable steps to check that the fund manager is suitable and monitor that he is carrying out his work competently.

Limits on employer-related investment (s40 Pensions Act 1995)
This section sets out the limits on 'employer-related investments':

- Not more than 5 per cent of the fund in shares of employer (or associate).
- No employer-related loans (includes not recovering a debt when due).

Note that there is a wide definition of 'associate' – it includes other companies which have a common director with an employer.

Cash to be in a bank (s49 Pensions Act 1995)
Cash must be held in a bank (or in an account, with proper records kept).

Implied investment power (s34(1) Pensions Act 1995)
This sub-section contains a wide implied investment power for trustees, subject to any restriction imposed by the scheme. Trustees have power to 'make an investment of any kind as if they were absolutely entitled to the assets of the scheme'. However, there are doubts whether the term 'investment' includes non-income producing assets.

Provision for employer consent is ineffective (s35(4) Pensions Act 1995)
Neither the scheme nor the statement of investment principles (SIP) can limit investment powers by reference to the consent of the employer.

Power to delegate to fund managers (s34(2) Pensions Act 1995)
Power is given to trustees to delegate investment discretions to fund managers or a committee of trustees etc, but not otherwise.

Statement of investment principles (SIP)

s35(1) Pensions Act 1995
Trustees must prepare (and periodically revise) a SIP.

ss35(2) and (3) Pensions Act 1995
The SIP must cover the trustees' policy on:

- diversification and suitability of investments;
- meeting the minimum funding requirement (MFR);
- kinds of investments to be held;

- balance between different kinds of investment;
- risk;
- expected return on investments;
- realisation of investments;
- the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments; and
- the exercise of the rights (including voting rights) attaching to investments.

s35(5)(b) Pensions Act 1995
Trustees must consult with the employers before preparing or revising the SIP. The recent *Pitmans* case (2004) says consultation must:

- be genuine;
- allow enough time for the employers to consider the SIP or revised SIP and respond; and
- include sending sufficient information for the employers to understand the position.

Consultation must be with all participating employers (unless one has been nominated by them to act as representative for them all).

s35(5)(a) Pensions Act 1995
Trustees must obtain written advice from a suitable person (with practical experience of financial matters etc) before preparing or revising the SIP.

s36(2) Pensions Act 1995
Trustees (and fund managers) must have regard to:

- the need for diversification; and
- the suitability to the scheme of investments proposed.

s36(5) Pensions Act 1995
Trustees (and fund managers) must seek to comply with the SIP so far as reasonably practicable.

ss36(3) (4) and (6) Pensions Act 1995
Trustees must obtain and consider proper written advice on whether investments are suitable. The advice must generally be from an authorised person under the FSMA (if it relates to FSMA investments)

Myners report (2001)

For more detail, see our client guide *Myners and legal aspects of pension scheme investment* (May 2002).

Myners' findings

These can be summarised as follows:

- trustees lack necessary resources and expertise;
- there is too much blind reliance on investment consultants;
- there is insufficient attention to asset allocation; and
- objectives are not linked to the pension fund.

Actions

Myners recommended that trustees:

- reassess expert advice;
- set out objectives;
- focus more on asset allocation;
- beef up investment agreements;
- focus more on transaction costs;
- encourage greater shareholder activism (eg vote the shares held by them);
- provide greater transparency for members; and
- be more effective at decision-making.

What will the Pensions Bill say?

If enacted, the Pensions Bill currently before parliament will include various provisions dealing with investment issues. Some of these derive from Myners' recommendations. Others come from the European Directive on Institutions for Occupational Retirement Provision (the IORP Directive).

Briefly, the Bill is likely to provide for:

- a duty on trustees to be 'conversant with' trust documents (including the SIP);
- a duty for trustees to have 'knowledge and understanding' of:
  – pensions and trusts law; and
  – funding; and
  – investment.
- regulations to lay down investment limits; these will probably:

- require investment 'predominantly' on regulated markets;
- limit use of derivatives; and
- allow borrowing only in limited cases.

What are the trustees' fiduciary duties?

For non-professional trustees the prudence standard was laid down by the courts in *Learoyd v Whiteley* (1887) 12 App Cas. 727:

'to take such care as an ordinary prudent man would take if he were minded to make an investment for other people for whom he felt morally obliged to provide.'

A professional trustee has an even higher duty – commensurate with the level of service he purports to provide – *Bartlett v Barclays Bank Trust (No 1)* [1980] 1 Ch 515.

Factors for the trustees to consider

- The courts have moved away from the rigid approach of considering the 'riskiness' of each investment in isolation. Hoffmann J (as he then was) in *Nestlé v National Westminster Bank plc* [1994] 1 All ER 118, considered that trustees should be judged by modern portfolio theory. The risk level of the whole portfolio is, therefore, considered rather than individual investments.
- Trustees must seek to act impartially among the various classes of beneficiaries: *Cowan v Scargill* [1985] Ch 270.
- Trustees should take advice. Although not bound by that advice, a trustee is not entitled to reject it unless this complies with the reasonableness and prudence test: *Cowan v Scargill* [1985] Ch 270.
- Trustees should consider the impact on the employer – *Edge v Pensions Ombudsman* [2000] Ch 602 and *Alexander Forbes Trustee Service v Halliwell* (2003). Depending on the scheme rules, the employer may be a residuary beneficiary on a winding-up. It may also be considered a quasi beneficiary under the scheme because it is the ultimate funder of any defined benefits. In addition, the trustees need to consult the employer on the SIP – section 35(4) Pensions Act 1995.

For defined benefit schemes, trustees should take account of the employer's investment recommendations on the following grounds.

- It retains the employer's goodwill, which is often in the best interests of the scheme members (eg because funding may be improved, future service benefit provision is more likely to continue).
- Arguably the employer is a quasi beneficiary in any event. It may not directly benefit in the form of cash being paid out of the scheme (at least before a winding-up), but it has a financial interest in the plan in that its contribution rate is affected by the investment decisions. If there is an adverse experience, the trustees will look to it to increase contributions.

The employers will be obliged to fund the scheme to meet the MFR and above this if the scheme is to continue.

Schemes often require the consent of the employer for various matters. Each scheme deed should be checked, but employer consent is often required:

- to augment benefits;
- to increase pensions in payment (over the statutory or deed minimum);
- to amend the scheme;
- to accept transfers-in;
- to make transfers-out (if not statutory);
- as to the level of contributions (subject to the MFR);
- to terminate participation;
- to wind up the scheme;
- to allow a member to be admitted late; and
- to allow a member to commute pension to a lump sum.

Money purchase assets

Pension schemes often include money purchase (defined contribution (DC) benefits). Even defined benefit (final salary) schemes will usually have some DC benefits, for example additional voluntary contributions (AVCs) or credited on individual transfers-in.

Here, obviously, the member's benefit is tied to the underlying investment performance. The employer may well be less concerned (unless there is a defined benefit underpin as well, eg a GMP underpin is sometimes found).

The issues concerning the investment of assets representing money purchase benefits include the following.

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- The money purchase assets must be covered by the SIP and by fund management agreements.
- It is usual for trustees to specify a range of funds available to members, but for members then to have the choice about where to invest within that range.
- Trustees often retain responsibility to review and monitor the range. Allowing the member to choose within the range is allowed by the FSMA. Trustees should make this clear to the member (it also helps to include provisions on this in the trust deed).
- Generally there is no duty to advise the member, but trustees should pass information from fund managers/AVC providers to the member. There may well be an obligation to ensure that the member is aware of details that he or she could not otherwise find out (eg changes in interest rates paid or that there is a guaranteed annuity rate option in an insurance contract – see the Pensions Ombudsman determination in *Wood v Royal Mail Pension Plan* (November 2003, [L003362]).
- If trustees (or employers) do in fact give investment advice (as opposed to mere information) they may well be liable if they are negligent (see eg the Court of Appeal in *Lennon v Metropolitan Police Commissioner* [2004] EWCA Civ 130).

Investment management agreements

In practice, only the largest schemes are likely to be authorised under the FSMA and to have their own internal fund managers. Most schemes will need to appoint a fund manager. Legal issues to be considered include the following.

- Is there a segregated fund (ie with assets identified as belonging to the scheme) or will a pooled vehicle (unit trust, insurance policy etc) be used?
- For a pooled arrangement, there is likely to be little scope to negotiate the standard terms of business used by the provider. Trustees should be aware of any issues that could arise (eg the agreement may well include tax indemnities from the trustees, and there are likely to be various discretions given to the provider, eg on dilution charges, exit charges etc).
- Insurance policies give rise to particular problems if used as a general investment vehicle. The Inland Revenue rules seem to prohibit this use by pension funds, but this does not stop them being sold by providers (who then look for an indemnity from the trustees if in fact the Revenue ever takes the point).
- For a segregated arrangement the fund manager is likely to have a standard form that it will look to apply. This is likely to make it clear that the fund manager does not owe any absolute duty to guarantee a particular return – only to act competently (and without negligence). Trustees need to consider from the outset of negotiations with a fund manager what level of expertise they are looking for. Any targets or risk profiles will need to be expressly built in to the IMA. The fund manager is also likely to look for indemnities from the trustees.

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