

LEGAL INVESTMENT ISSUES IN DB AND DC PENSION FUNDS IN THE UK

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■ Legal investment issues in DB and DC pension funds in the UK

- Part I: Introduction
- Part II: Legal framework for UK pension fund investments
- Part III: Defined benefit pension fund: investment issues
- Part IV: Defined contribution pension fund: investment issues
- Part V: Conclusions

■ Part I: Introduction

- UK pension funds: brief overview of legal structure
- Key legal relationships in UK pension fund trusts

■ Part I: UK pension funds: brief overview of legal structure

- UK pension schemes divide into 2 categories:
 - > personal pension schemes, and
 - > occupational pension schemes
- personal pension schemes are set up by insurance company / other financial institution
- personal pension scheme membership not tied to particular employment or occupation
- benefits, other than risk benefits, are money purchase

■ Part I: UK pension funds: brief overview of legal structure (cont'd)

- occupational pension schemes set up by employer of member (or another company in the same corporate group)
- occupational pension schemes
 - > unfunded, or
 - > funded and set up, usually, under trust
- this talk looks at legal investment issues for occupational pension schemes set up under trust
- I refer to these as "pension funds"

■ Part I: Key legal relationships for UK pension fund trusts

- contract of employment

"Employee may become member of pension fund on terms of Trust Deed. Employer reserves right to amend pension fund, terminate pension fund or terminate membership"

- contract of employment also refers to scheme booklet (summarising benefits and contributions)
- scheme booklet would normally include "boilerplate" to effect that no rights conferred other than by Trust Deed

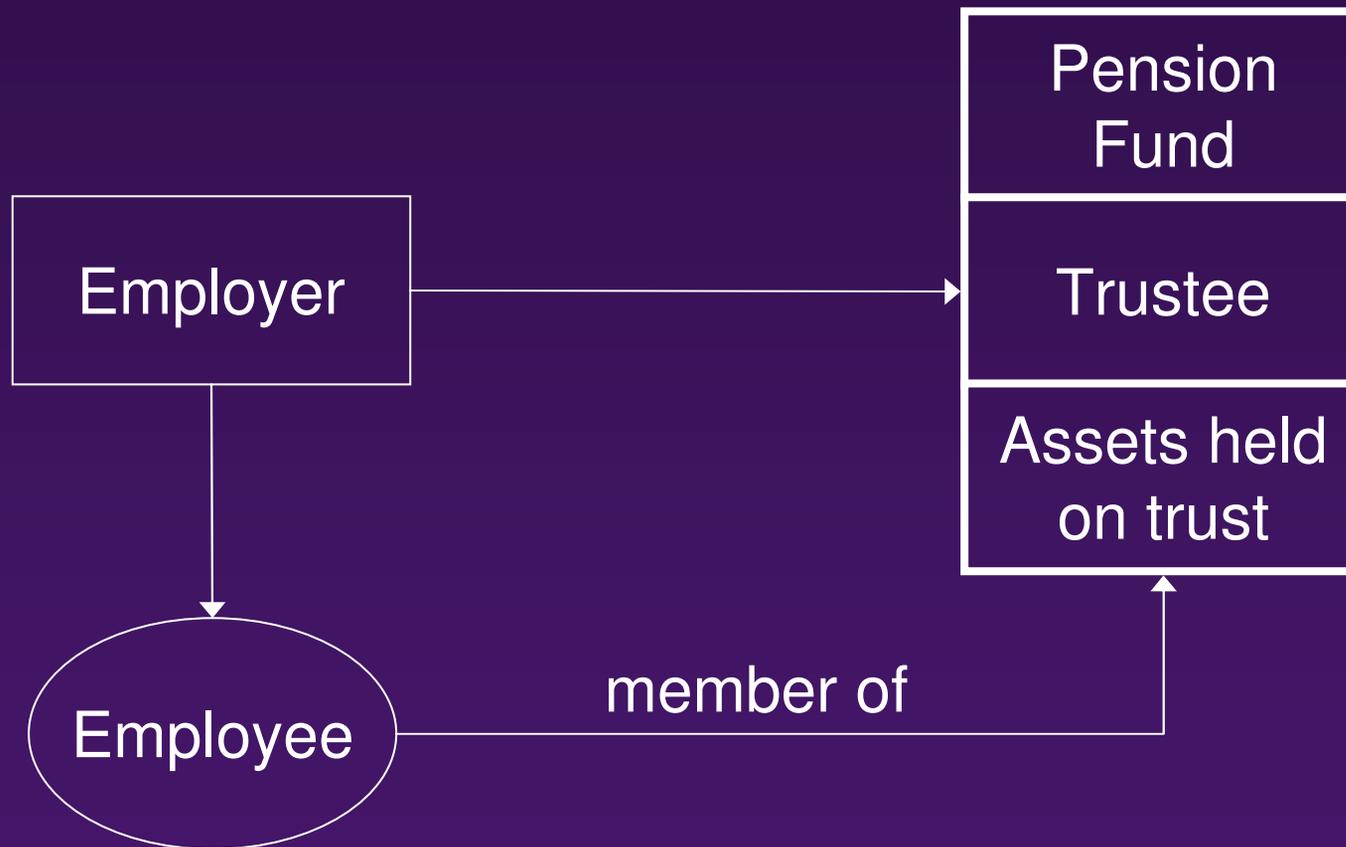
■ Part I: Key legal relationships for UK pension fund trusts (cont'd)

- under English law, trust, unlike company, has no separate legal personality
- trustee holds assets on trust (ie separate from trustee's personal assets) to provide benefits, as per Trust Deed, on retirement or earlier death for members

■ Part I: Key legal relationships for UK pension fund trusts (cont'd)

- important to remember that general trust law rules apply to occupational pension scheme trusts
- but, general trust law rules can be modified (or, in most cases, excluded) by terms of Trust Deed
- "freedom of contract" and "freedom of trust"
- but: "freedom of trust" subject to restriction imposed by pensions and tax legislation
- trustees may be individuals/companies/sole corporate trustee (but separate rules on how trustee board is composed)

■ Part I: Key legal relationships for UK pension fund trusts (cont'd)



■ Part II: Legal framework for UK pension fund investments

- legal rules that apply to pension fund trustee when investing
- can UK pension fund trustees exclude liability for investment duty breaches?
- does UK pension fund trustee have a duty to advise members?

■ Part II: Legal rules that apply to pension fund trustee when investing

- trustee can only invest within powers of investment set out in Trust Deed
- Trust Deed can provide wide or limited powers of investment

Note: Important tool for defining scope of trustee's investment duties

- but any restrictions on investment powers by reference to consent of employer are overridden by UK legislation

■ Part II: Legal rules that apply to pension fund trustee when investing (cont'd)

- overriding investment restrictions under UK Pensions Act:
 - > must invest predominantly on regulated markets and certain other restrictions (see later)
 - > self-investment in sponsoring employer generally restricted to less than 5% of pension fund assets
 - > restriction on who trustee may delegate investment functions to (normally to investment manager authorised under UK financial services legislation)

■ Part II: Legal rules that apply to pension fund trustee when investing (cont'd)

- power of investment must be used to promote purpose of pension fund (not for some alternative purpose)
- must be exercised in best interests of present and future beneficiaries
- hold scales impartially between different classes of beneficiaries **(see later for position of employer as residual beneficiary)**
- investment powers exercise fairly and honestly

■ Part II: Legal rules that apply to pension fund trustee when investing (cont'd)

- when investing trustee subject to prudent person rule:

"to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide".

Source: Lindley, LJ, in Learoyd v Whiteley [1986] LR33 Ch.D.347

- trustee must seek advice on matters which trustee does not understand

Note: Honesty and sincerity are not the same as prudence and reasonableness

- must exercise investment powers so that investments are properly diversified

■ Part II: Legal rules that apply to pension fund trustee when investing (cont'd)

- trustee investment duties now substantially codified but, broadly, as outlined earlier
- key change is that:

"trustee must invest assets of pension fund

- ***in best interests of members and survivors of members, and***
- ***in case of a potential conflict of interest, in sole interests of members and survivors"***

Note: Where employer is residual beneficiary, interests of employer in that capacity must be disregarded in case of potential conflict

■ Part II: Legal rules that apply to pension fund trustee when investing (cont'd)

- UK pensions legislation requires trustee to prepare and maintain statement of investment principles which includes:
 - > policy on extent (if at all) to which social, environment and ethical considerations are taken into account in selection, retention and realisation of investments, and
 - > policy (if any) in relation to exercise of rights (including voting rights) attaching to investments

■ Part II: Legal rules that apply to pension fund trustee when investing (cont'd)

- trustee may only invest, as distinct from delegating investment management, assets of pension fund if investment decision is taken after obtaining "**proper advice**"
- criminal offence for trustee to take day to day investment management decisions with certain limited exceptions

Note: In practice day to day delegated by trustees to authorise investment managers

- but investment by trustees in most pooled investment vehicles is not day to day investment management so long as "proper advice" obtained

■ Part II: Can UK pension fund trustees exclude liability for investment duty breaches?

- under "freedom of trust" rules usual for Trust Deed to exclude all liability other than for bad faith or fraud
- but, in relation to investment functions, UK pension legislation states that:

"liability for breach of an obligation under any rule of law to take care or exercise skill in the performance of any investment function... cannot be excluded or restricted by any instrument or agreement"

Note 1: Excluding or restricting liability very widely defined

Note 2: Potential safe harbour for trustees who delegate investment functions (or exercise due care in the selection and monitoring of delegates)

Source: See Section 33 of UK Pensions Act 1995

■ Part II: Can UK pension fund trustees exclude liability for investment duty breaches? (cont'd)

- additional defence for trustee (pre-Section 33 Pensions Act 1995) if member had agreed to breach of duty (subject to certain conditions being satisfied)

Note: This issue relevant where trustee follows member's request as to how member's retirement account is invested in DC pension fund (see later)

■ Part II: Does UK pension fund trustee have a duty to advise members?

- under UK law general rule: no duty on trustee to advise member
- but if advice given, or information supplied, duty of care should be assumed to apply
- where advice or information given **on behalf** of trustee, general rule is that trustee is liable as well as agent
- but liability can be limited or excluded by appropriate boilerplate

■ Part III: Defined benefit pension fund: investment issues

An investment question:

- Would you buy shares in a company
- for a price of £100 per share (£2 paid on subscription and £98 payable 1 month later)
- in return for which you will be entitled to £100 a year dividends
- whose prospectus contained the following statement:

"A company for carrying on an undertaking of great advantage but nobody to know what it is" until 1 month after £2 per share paid

- **How many people bought shares in this company?**

■ Part III: Defined benefit pension fund: investment issues

What duties are owed to **employer** by trustee
when investing pension fund assets?

■ Part III: Defined benefit pension fund: investment issues (cont'd)

- under UK legislation employer liable to make up shortfall in pension fund assets
- cost of providing pension benefits directly affected by trustee's decisions on:
 - > asset allocation
 - > choice of investment manager
 - > mandate given to investment manager

■ Part III: Defined benefit pension fund: investment issues (cont'd)

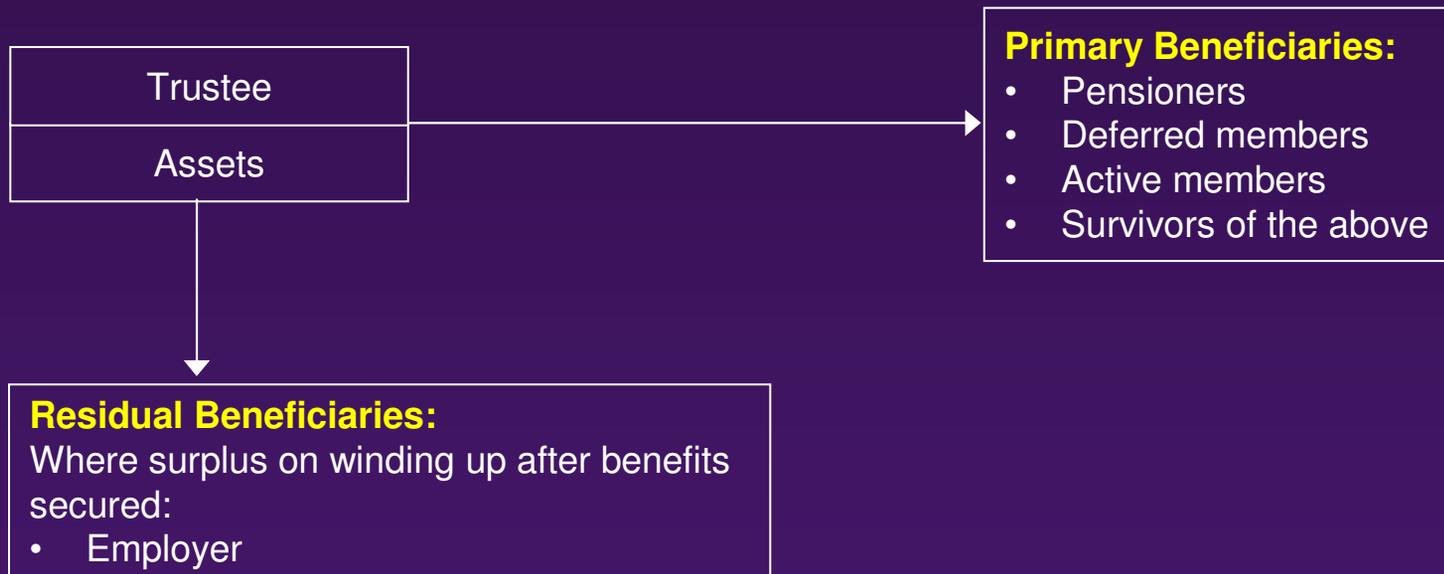
- trustee has statutory duty to consult with employer when establishing pension fund's statement of investment principles
- consultation must be:

“a communication of a general invitation to give advice and a genuine consideration of that advice. In my view to achieve consultation, sufficient information must be supplied by the consulting party to the consulted party to enable it to tender helpful advice.”

Source: [Pitmans Trustees v The Telecommunications Group \[2004\] EWHC 181\(Ch\)](#) at paragraph 56 (following previous authority) as to what the concept of “consultation” meant”.

■ Part III: Defined benefit pension fund: investment issues (cont'd)

- duty to employer as residual beneficiary under trust



Note: Duty to employer as residual beneficiary must be subservient, under English legislation, to investing in best interests of members and their survivors.

■ Part III: Defined benefit pension fund: investment issues (cont'd)

- does the trustee owe a duty of care in tort to the employer when investing
- does the trustee owe, separately from its trust law duty to the residual beneficiary, a duty of good faith:

“the employers will not, without reasonable and proper cause, conduct themselves in a manner calculated or likely to destroy or seriously damage the relationship of trust and confidence between employer and employee.”

Source: Imperial Group Pension Trust Limited and Others v Imperial Tobacco Limited and Others [1991] 2 All ER 597.

- Query: can it be argued that a reciprocal obligation is owed by the trustee to the employer?

■ Part IV: Defined contribution pension fund: investment issues

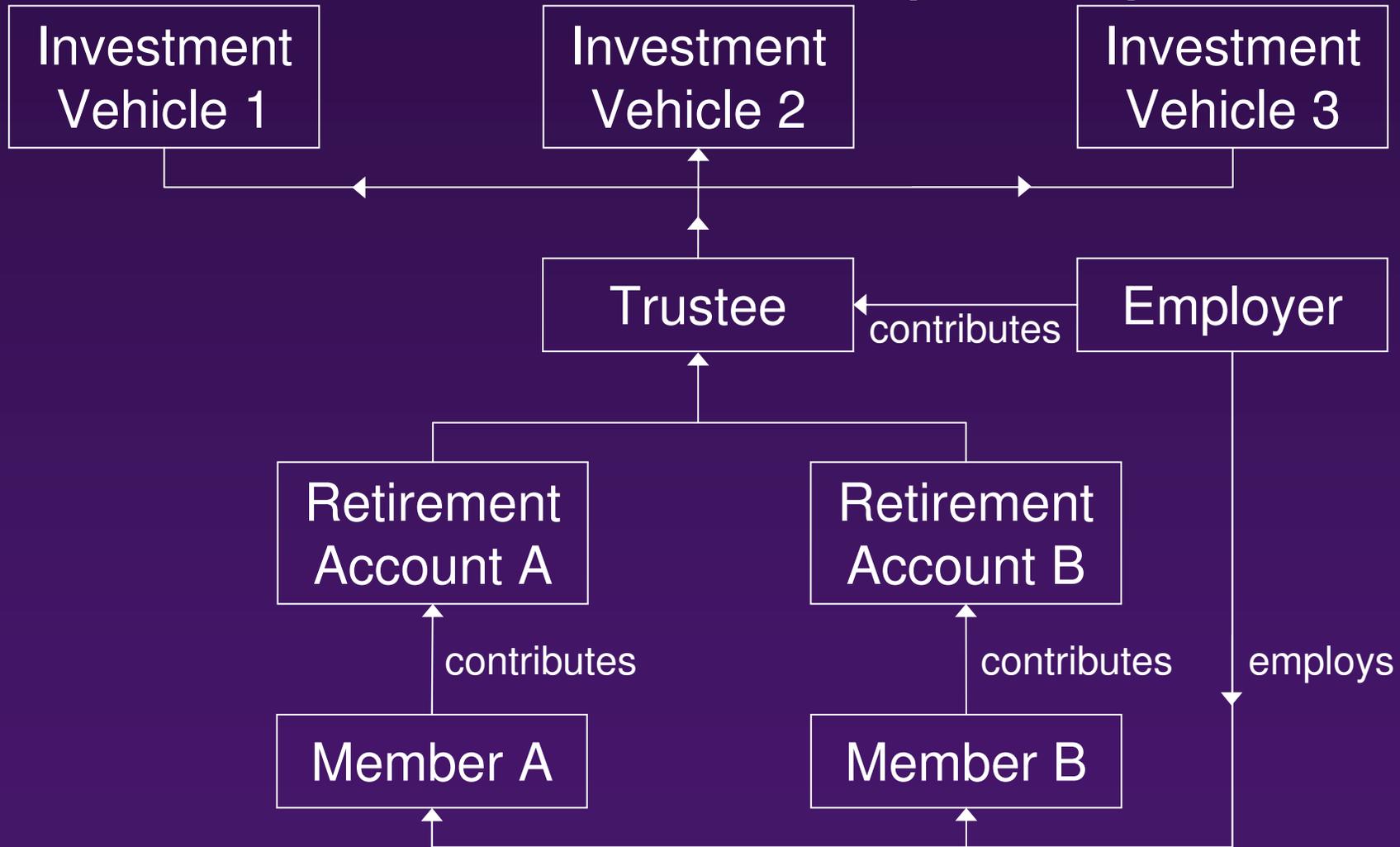
- DC pension fund prudent person rule and member investment requests
- lifestyle investment options issues
- employer (inadvertent) liability for fees and expenses
- timing issues on DC investment/disinvestment of member's retirement account
- management of legal risk in DC fund member communications

■ Part IV: Defined contribution pension fund: investment issues (cont'd)

- does prudent person rule require trustee to second guess investment request of member in relation to his retirement account?
- what if member requests trustee to invest all of retirement account for 20 years in cash fund option only?
- reminder of prudent person rule:

"to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide."

Part IV: Defined contribution pension fund: investment issues (cont'd)



■ Part IV: Defined contribution pension fund: investment issues (cont'd)

- if trustee has power to overturn member's investment requests under Trust Deed, and
- trustee cannot exclude liability for breach of prudent person rule,
- does the trustee have an exposure?
- use of "duty defining" approach to drafting Trust Deed to manage this risk

■ Part IV: Defined contribution pension fund: investment issues (cont'd)

- if trustee has wide powers of investment, can it only invest in investment products of a particular investment product provider even if
 - > investment performance is worse, or
 - > charges are higher

■ Part IV: Defined contribution pension fund: investment issues (cont'd)

- trustee behaviour and legal risk management
- issue of mandatory deselection of underperforming funds or simply closing to new money
- population explosion of underperforming investment products closed to new money

■ Part IV (cont'd): Lifestyle investment options issues

- typical UK lifestyle investment option
 - > **100%** equities (index tracking) until **10 years** before chosen retirement date
 - > **at end of 10 year period**, invested **75%** in long dated bonds (also index tracking) and **25%** cash

■ Part IV (cont'd): Lifestyle investment options issues

■ problem areas

- > exactly how does the switching work over 10 year period from 100% equities to position at target retirement date
- > adequately covered in member communication?
- > what happens to contributions during this period?
- > is any rebalancing back to target benchmark done during this period?

■ **lifestyle investment option as default investment option?**

■ Part IV: Lifestyle investment options issues (cont'd)

- is lifestyle an appropriate default investment option?
- conventional "wisdom" that investors with long time horizons should invest more heavily in equities than investors with a short time horizon
- "risk of equity investments diminishes with length of your time horizon"?

Note: Not according to option pricing theory

- In UK, changes from 6th April, 2006 as to retirement options (not just annuity and cash but also income drawdown and up to 5 year annuities)

■ Part IV: Employer (inadvertent) liability for fees and expenses

- normal UK approach for pension funds
 - > member's retirement account bears investment charges (and, perhaps, some element for record keeping expenses)
 - > all other expenses borne by sponsoring employer
- but gives rise to "deferred member population explosion"

Note: No incentive to transfer out

■ Part IV: Employer (inadvertent) liability for fees and expenses (cont'd)

- has employer adequately reserved right to pass on costs to member's retirement accounts?
- has this point been clearly communicated in pension fund booklet?
- problems on winding up defined contribution pension funds and costs

■ Part IV: Timing issues on DC investment/disinvestment of member's retirement account

- Position if Trust Deed silent on time for investment/disinvestment of contributions / retirement account balances
- Pensions Ombudsman case held that 5 days (**not working days**) was sufficient for investment of contributions
- Manage risk through Trust Deed wording:
 - > long stop date, plus
 - > force majeure clause

■ Part IV: Management of legal risk in DC fund member communications

- creative ? tension between
 - > communications consultants writing investment booklet, and
 - > lawyer trying to manage legal risk

■ Part IV: Management of legal risk in DC fund member communications (cont'd)

- *“I began to wonder how different it would have been if my fellow passenger was reading traditional, standard pensions literature, prepared by stuffy lawyers.”*
- *I would not have been able to read the long paragraphs of close, tight text and the ‘blame avoidance’ jargon would have sent me to sleep. I am not alone in my thinking.”*

Source: Matt Frost, Winner – Best Communications Specialist for Pension Schemes 2003 Pensions Management Provider Awards, Pensions World September, 2003.

- **Part IV: Management of legal risk in DC fund member communications (cont'd)**
 - the lawyer's view on the communications specialist?:
 - > only wants to tell the good news!?
 - > is not bright enough to understand legal relationships and risks!?
 - > habitually "economical with the truth"!?
 - > likes to write unqualified superficial statements creating additional legal risk and liability for trustee and employer!?

- **Part IV: Management of legal risk in DC fund member communications (cont'd)**
 - claims arising from member communications tend to be based on 3 main grounds:
 - > negligent misstatement
 - > estoppel (prevents trustee/employer from denying a state of affairs)
 - > incorporation of statement into contract of employment

■ Part IV: Management of legal risk in DC fund member communications (cont'd)

- 3 elements of negligent misstatement claim:
 - > was duty of care owed by maker of statement to recipient
 - > is the statement incorrect
 - > did member rely on statement to his detriment

■ Part IV: Management of legal risk in DC fund member communications (cont'd)

- measure of damages under English law for negligent misstatement:

“Compensation ... should put the plaintiff in the same position as if the informant had performed his duty in providing correct information - not to put him in the position in which he would have been if the incorrect information had been correct.”

Source: Westminster City Council -v- Hayward, [1996] 2 All ER 461 at 481, High Court decision of Robert Walker J.

■ Part IV: Management of legal risk in DC fund member communications (cont'd)

- estoppel by convention:

“When the parties to a transaction proceed on the basis of an underlying assumption - either of fact or law - whether due to misrepresentation or mistake makes no difference - on which they have conducted the dealings between them - neither of them will be allowed to go back on that assumption when it would be unfair or unjust to allow him to do so.”

Source: Amalgamated Investment & Property Co. Ltd -v- Texas Commerce International Bank Ltd [1982] 1 QB 84

■ Part IV: Management of legal risk in DC fund member communications (cont'd)

- test as to whether statement/misstatement incorporated into contract of employment:
 - > is there an intention to create contractual relations
 - > has offer and acceptance occurred
 - > is there sufficient certainty
 - > is there "consideration"
- if so, member can claim damages for breach of contract

Note: Different measure of loss – put complainant in same position as he would have been in had incorrect information been correct.

■ Part IV: Management of legal risk in DC fund member communications (cont'd)

- use of boilerplate or disclaimer to manage legal risk in communications **but**
- assume cannot manage material misstatement

■ Part IV: Management of legal risk in DC fund member communications (cont'd)

- example of current case
- trustee required by Trust Deed to disinvest member's investment account invested in with profits insurance policy
- insurance company applied "market value adjustment" causing perceived loss by member
- member asserted that he would not have invested in this investment had he been aware that the trustee could disinvest without member being informed
- **point was not covered in pension fund investment booklet**

■ Part IV: Management of legal risk in DC fund member communications (cont'd)

- suggestion for managing legal risk in this area - try test of:

"In what circumstances is the statement not true?"

Note: Truth may have a different meaning for lawyers and communications specialist

- pension funds operate on long time horizons (decades rather than months)
- longer the time horizon, greater the possibility that one of the more remote outturns will occur
- for example, defined benefit scheme caps pension increases at 3% or price inflation, if lower, but booklet only refers to 3% increases

■ Part V: Conclusions

- Defined benefit pension funds
 - > pressure on relationship between trustee and employer (deficits)
 - > trustee and employer interests no longer aligned
 - > trustee seeking higher funding security (plus change to regulatory regime)
 - Note:** Query purchase of long dated bonds at top of market
 - > employer seeking to reduce costs
- all bring focus on trustee investment duty to sponsoring employer

■ Part V: Conclusions (cont'd)

- **clear** trustee duty to go through meaningful consultation process with employer in preparing statement of investment principles
- **reasonably clear** duty owed to sponsoring employer as residual beneficiary (but subservient to duty owed to members and those in receipt of survivor's benefits) when investing
- **possible** duty of care owed separately to employer when investing
- **possible** separate duty of good faith in dealing with employer

■ Part V: Conclusions (cont'd)

- DC pension funds have a different type of legal risk
- retired member has the rest of his life to reflect on trustee/employer's errors
- easy, in the UK, for pension fund member to litigate (via Pensions Ombudsman)

■ Part V: Conclusions (cont'd)

- need to manage legal risk for DC pension fund investments
- restrict trustee's discretion under terms of the Trust Deed?
- make sure there is clear wording in Trust Deed as to time limits within which contributions should be invested and retirement account balances disinvested (and note force majeure clause)
- must have well organised zero error culture for administration process
- communication material must be accurate and clear (and properly validated)

Note: Disclaimers help but do not cover all risks

■ Part V: Conclusions (cont'd)

- ***"No man is above the law, not even the king"*** or even a communications specialist!
- Source: Sir Edward Coke in relation to King Charles I (**later beheaded**)