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

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Author: Philip Bennett

PART I

Introduction

A. Introduction and structure of this paper

1. This paper looks at a number of legal investment issues for trustees and employers in relation to defined benefit and defined contribution occupational pension schemes set up under trust in the UK.

2. The paper is divided up into the following sections:

- **Section B** – UK pension schemes: brief overview of legal structure
- **Section C** - The legal relationships in relation to UK occupational pension schemes established under trust
- **Section D** – The legal rules that apply when investing the assets of a UK occupational pension scheme established under trust
- **Section E** – Extent to which the trustee of a UK pension fund can restrict or limit liability for breach of trust in relation to investment matters
- **Section F** – Does the trustee of a UK pension fund have a duty to advise members of the pension fund?
- **Section G** – Does the trustee owe any duty to the employer when investing the assets of a defined benefit pension fund?
- **Section H** – Some preliminary issues in relation to defined contribution pension fund investments
- **Section I** – Issues for lifestyle investment options
- **Section J** – DC pension funds: issues relating to fees and expenses and the member's retirement account balance

- **Section K** – Timing issues in terms of investment/disinvestment of contributions to/payments out of a member's retirement account in a defined contribution pension fund

- **Section L** – Management of legal risk in DC fund member communications

- **Section M** - Concluding thoughts

B. <u>UK pension schemes: brief overview of legal structure</u>

1. Pension schemes in the UK divide for legislative purposes into 2 broad categories:

   - personal pension schemes, and

   - occupational pension schemes.[1]

2. Personal pension schemes are generally set up by insurance companies or other financial institutions. Benefits, other than risk benefits such as death in service benefits, are money purchase benefits. Membership of a personal pension scheme is not tied to a particular employment or occupation.

3. In contrast, occupational pension schemes will, in general terms, be set up by the member's employer or by a company in the same group of companies as the company which employs the member.[2]

4. Occupational pension schemes will either be unfunded or set up under trust and funded.

5. The terms "pension scheme", pension plan" and "pension fund" are, for a funded occupational pension scheme, used interchangeably in the UK pensions world. There are, however, no statutory definitions of "pension fund" or "pension plan" (as noted above "occupational pension scheme" and "personal pension scheme" are both defined in legislation).

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[1] See Section 1 of the Pension Schemes Act 1993 for definitions of "personal pension scheme" and "occupational pension scheme".

[2] It is also possible for an occupational pension scheme to provide cover for employees working in a particular industry sector (for example, for the electricity supply industry). Special considerations apply to this type of industry-wide occupational pension scheme which are outside the scope of the paper.

C. <u>The legal relationships in relation to UK occupational pension schemes established under trust</u>

1. The first legal relationship to consider is that between the employer and the employee under the contract of employment.

2. A typical employment contract will state that the employee may become a member of the employer's pension scheme, on the terms and subject to the conditions of the pension scheme Trust Deed, as from time to time in force, and that the employer will reserve the right to amend the terms of the scheme, to terminate the scheme or to terminate the employee's membership of the scheme.

3. The employment contract will also refer to further details of the scheme being set out in the scheme booklet accompanying the contract of employment.

4. The scheme booklet will then summarise the contributions to be paid to the scheme by the member and, for money purchase schemes, by the employer and the benefits provided under the scheme.

5. The booklet will normally include some "boilerplate"[3] which will make it clear that the booklet confers no rights to benefits, rights to benefits are conferred solely by the terms of the Trust Deed and Rules and that a copy of the Trust Deed and Rules is available on request.

6. So long as no material misrepresentation has been made in the scheme booklet or in any other communication to the employee on which the employee is entitled to rely, the legal relationship between the member, the employer and the trustees of the occupational pension scheme, will, in general terms, be governed by the Trust Deed of the pension scheme.

7. It is common to refer to the Trust Deed and Rules of the pension scheme. In practice, the rules are simply a part of the Trust Deed setting out the contributions and benefits payable.

8. Under the contract of employment, legal rights are enforceable under the law of contract.

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[3] The boilerplate will cover circumstances where the booklet contains a reasonable summary of the position. It will not cover the situation where the booklet contains a material misrepresentation. See, for example, <u>Hutchinson v. Steria Ltd</u> [2005] EWHC 2993(Ch).

9. Where the employee derives his rights from the terms of the Trust Deed, his rights will be enforceable under trust law.

10. Under English law, a trust, unlike a company, has no separate legal personality.

11. Instead, the trustee holds the assets which are contributed to the trust to be applied in accordance with the Trust Deed constituting the trust.

12. In the case of an occupational pension scheme, the Trust Deed will specify that the assets are to be held on trust by the trustee and used to provide benefits on retirement, or on earlier death, of the members in accordance with the terms of the Trust Deed.

13. There are then a number of general trust law rules which apply in relation to a UK occupational pension scheme established under trust.

14. Under English law the starting presumption is that any general trust law rule is capable of being modified by the terms of the Trust Deed. Just as the phrase "freedom of contract" can be applied to contracting parties, so the phrase "freedom of trust" can apply to employers setting up pension scheme trusts.

15. That "freedom of trust" rule is, however, subject to restrictions imposed by overriding pensions legislation (principally the Pension Schemes Act 1993, the Pensions Act 1995 and the Pensions Act 2004 and associated regulations) and tax legislation[4] for tax approved pension schemes set up under trust.

16. Trustees of a pension fund may be individuals, a mixture of individuals and bodies corporate or may be a body corporate, including a company which has, as its sole purpose, to act as trustee of a particular pension fund. Additional rules govern the composition of trustee bodies of pension funds which are outside the scope of this paper.[5] In the rest of this paper the term "trustee" is used to cover the various types of trustee structure.

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[4] The Income and Corporation Taxes Act 1988, Part XIV, Chapter I to be replaced by the Finance Act 2004, Part 4 from 6th April, 2006.

[5] See Sections 16 to 21 of the Pensions Act 1995 (to be amended from 6th April, 2006 by the Pensions Act 2004).

PART II

The legal framework which applies to investments which are to be made by the trustee of the UK pension fund

D. The legal rules that apply when investing the assets of a UK occupational pension scheme established under trust

The general trust law rules which apply in relation to the investment of assets of a UK occupational pension scheme established under trust (called, in the rest of this paper, a “pension fund”) can be summarised as follows:

1. The assets of the pension fund may only be invested within the powers of investment of the pension fund.

   Note: This rule is important as it can be used to manage legal investment risk (see **H** below).

2. Those investment powers will be set out in the Trust Deed governing the pension fund.

3. But additional investment powers may be imported under Section 34 of the Pensions Act 1995 (unless excluded or restricted by the terms of the Trust Deed – but any restriction on investment powers by reference to the consent of the employer is overridden by Section 35 of the Pensions Act 1995).

4. Legislative restrictions on investments made by a pension fund trustee are also imposed by Section 36 of the Pensions Act 1995 and associated regulations (investments of pension funds to be made predominantly on regulated markets and certain other restrictions – see **11** below) and Section 40 of the Pensions Act 1995 which, in general terms, restricts investments by the pension fund in the sponsoring employer to less than 5% of the assets of the pension fund.

5. The general trust rule is that the trustee cannot delegate its powers or discretions unless authorised to do so by the terms of its trust. The Pensions Act 1995, Section 34 confers an overriding power on trustees to delegate their investment functions to certain limited class of permitted delegates (these will include investment management companies authorised to carry on business as such in the United Kingdom) but also provides that the delegation of investment functions to other persons is outside the powers of the trustees.

6. The power of investment must be used to promote the purposes of the pension fund and not for some alternative purpose and must be exercised by the trustee in the best interests of the present and future beneficiaries of the trust, holding the scales impartially between the different classes of beneficiaries.[6]

Note: This has been modified slightly from 30th December, 2005 (see further **11** below).

7. The investment powers of the trustee must be exercised fairly and honestly for the purpose for which they are given and not so as to accomplish any ulterior purpose, whether for the benefit of the trustee or otherwise.

8. When investing, the trustee is required to adopt the 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".[7]

9. The trustee is under a duty to seek advice on matters which the trustee does not understand, such as the making of investments and, on receiving that advice, to act with the same degree of prudence. This requirement is not discharged merely by showing the trustee has acted in good faith and with sincerity. Honestly and sincerity are not the same as prudence and reasonableness.[8]

10. A number of these general trust law duties in relation to investments have been codified in relation to a pension fund and so the previous ability to modify the general trust law rules by the terms of the Trust Deed have been overridden[9].

11. The now codified requirements may be summarised as follows:

11.1 the trustee must invest the assets of the pension fund:

- in the best interests of the members and beneficiaries, and
- in the case of a potential conflict of interest, in the sole interests of members and beneficiaries[10].

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[6] See Cowan v Scargill [1985] Ch 270

[7] See Lindley, LJ. in Learoyd v. Whiteley [1886] LR33 Ch.D.347

[8] See Cowan v Scargill [1985] Ch 270 at page 286 – 9.

[9] See the Occupational Pension Schemes (Investment) Regulations 2005 which came into force on 30th December, 2005.

11.2 the trustee must exercise its investment powers in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio it holds.

11.3 for defined benefit schemes, the assets must be invested in a manner appropriate to the nature and duration of the expected future retirement benefits payable under the pension fund.

11.4 the trustee must exercise its investment power so that the assets of the pension fund consist predominantly of investments admitted to trading on regulated markets.

11.5 the trustee must exercise its investment powers in relation to the assets of the pension fund so that those assets are properly diversified in such a way as to avoid excessive reliance on a particular asset, issuer or group of undertakings and so as to avoid accumulations of risk in the portfolio as a whole.

12. The trustee is also required to prepare and maintain a written statement of investment principles governing decisions about investments for the purpose of the scheme (with such statement prepared after taking advice from an appropriate expert).[11]

13. The statement of investment principles must include the trustee's policies on:

- the kinds of investment to be held,
- the balance between different kinds of investment,
- risks, including the ways in which risks are to be managed,
- the expected return on investments,
- the 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

[10] Beneficiary is defined in Regulation 4(11) of the Occupational Pension Schemes (Investment) Regulations 2005 as meaning, in summary, a person entitled to survivor's benefits on death of a member.

[11] See Section 35 of the Pensions Act 1995.

- the policy (if any) in relation to the exercise of rights (including voting rights) attaching to investments.

14. The trustee may only invest the assets of the pension fund, if the investment decision is taken by the trustee, after obtaining "proper advice".[12]

15. With certain limited exceptions, it is a criminal offence for a trustee of a UK pension fund to take a day to day investment management decisions in relation to the assets of the pension fund.[13] This means, in practice, that day to day investment management is delegated by the trustee to an authorised investment management company or investments are made, with advice, in pooled investment vehicles.

E. Extent to which the trustee of a UK pension fund can restrict or limit liability for breach of trust in relation to investment matters

1. Prior to 6th April, 1997 there was considerable freedom, under trust law, to allocate risk between employers, trustees and members under the Trust Deed governing the pension fund.

2. It was common to exclude all trustee liability under the terms of the Trust Deed (including liability for negligence) other than for fraud or bad faith.

3. Furthermore, the trustee had a defence to a breach of trust if the member assented to, concurred or acquiesced in, the breach, or subsequently released or confirmed it, provided:

   - the member was over 18 and was not mentally incapacitated at the time of assent, concurrence, acquiescence or release (as the case may be),

   - the member had full knowledge of the fact, and knew what he was doing and the legal effect of his assent, concurrence or acquiescence,

   - in all the circumstances, it was just, fair and equitable that, having given his concurrence or acquiescence, the member should not subsequently sue the trustee, and

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[12] See Section 36 of the Pensions Act 1995.

[13] See Section 19 of the Financial Services and Markets Act 2000, coupled with the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 and the Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order 2001.

- no undue influence was brought to bear on the member to extort the assent, concurrence, acquiescence or release (as the case may be).[14]

4. However, Section 33 of the Pensions Act 1995 which came into force on 6th April, 1997 changed the rules here:

> "(1) Liability for breach of an obligation under any rule of law to take care or exercise skill in the performance of any investment functions, where the function is exercisable -
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> (a) by a trustee of a trust scheme, or
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> (b) by a person to whom the function has been delegated under section 34,
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> cannot be excluded or restricted by any instrument or agreement.
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> (2) In this section, references to excluding or restricting liability include -
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> (a) making the liability or its enforcement subject to restrictive or onerous conditions,
>
> (b) excluding or restricting any right or remedy in respect of the liability, or subjecting a person to any prejudice in consequence of his pursuing any such right or remedy, or
>
> (c) excluding or restricting rules of evidence or procedure.
>
> (3) This section does not apply -
>
> (a) to a scheme falling within any prescribed class or description, or
>
> (b) to any prescribed description of exclusion or restriction."

Note: There is a potential safe harbour from the impact of Section 33 under Sections 34(4) and 34(6) of the Pensions Act 1995 where investment decisions are delegated. But this safe harbour is not available where it is the trustee who takes the investment decision.

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14 See Underhill and Hayton 16th edn *The Law of Trusts and Trustees* at pages 931-938

5. The effect of Section 33 appears to be that a trustee is prevented from arguing, in defence to a claim for breach of trust, that the member acquiesced to the breach (because acquiescence is the same as an agreement which falls within Section 33(1)).

F. <u>Does the trustee of a UK pension fund have a duty to advise members of the pension fund</u>?

1. The general rule is that there is no duty on the trustee of a UK pension fund to advise the members of the pension fund.

2. The Court of Appeal in <u>Outram v Academy Plastics (2000) OPLR 321</u> ruled that the company as trustee had no duty of care to provide information and/or advice about the claimant's membership of the pension scheme.

3. A similar conclusion was reached by Lightman J in <u>HGS Pensions Agency and another v Pensions Ombudsman and Beechinor (1997) OPLR 99</u> where the Ombudsman had criticised trustees of a pension fund for failing to warn the complainant of the risks of joining a new scheme. Lightman J stated that the Ombudsman's decision depended upon whether the administrators owed the complainant a duty of care in tort. Of this he said (at p102A):

   "one matter is absolutely clear, that the administrators had no duty to advise or warn".

4. In <u>University of Nottingham v Eyett and another [1999] 2 All ER 437</u>, Hart J, whilst accepting this conclusion, added that he did not think that the principle underlying the implication of the term of mutual trust and confidence into the contract of employment:

   "necessarily excludes the possibility that it may, in appropriate circumstances, have a positive as opposed to a negative, content, although I recognise that so to hold would involve an extension of the existing law."

5. But a duty of care should be assumed to apply if the trustee does give advice.

PART III

Investment issues in relation to defined benefit pension funds

G. Does the trustee owe any duty to the employer when investing the assets of a defined benefit pension fund

1. In a UK defined benefit pension fund, the employer is now liable, under UK pensions legislation[15], to make good any shortfall in the pension fund's assets on a winding up of the pension fund or, while the pension fund is ongoing, to make good (usually over a recovery period) a deficit shown in an actuarial valuation of the pension fund.

2. If the trustee sets too conservative an investment policy, this can increase the cost of providing defined benefit pension benefits to the employer. Conversely, if the trustee adopts too aggressive an investment policy, that could lead to a higher level of risk in the investment strategy than the employer wished to take.

3. As noted in **D11**, the trustee has a duty to exercise its investment powers in relation to the assets of the pension fund:

   - in the best interests of members and beneficiaries,[16] and

   - in the case of a potential conflict of interest, in the sole interest of members and beneficiaries.

   Note: The employer is often the residual beneficiary under the pension fund if any assets remain after benefits have been secured in full on the winding up of the pension fund. So long as there is no conflict, the trustee's prudent person duty when investing should also extend to the employer in its capacity as residual beneficiary.

4. Section 35 of the Pensions Act 1995 requires the trustee to consult with the employer when establishing the pension fund's statement of investment principles.

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[15] Section 75 of the Pensions Act 1995 (Debt on the employer) and Sections 221-233 of the Pensions Act 2004 (Statutory funding objective).

[16] Beneficiary here means a person entitled to payment of survivor's benefits on death of the member.

5. Consultation for this purpose has been held to mean:

"The essence of consultation is 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 to the consulted party to enable it to tender helpful advice."[17]

6. An alternative approach is to consider whether the trustee owes a duty of care to the employer when investing.

7. The arguments here are based on applying the principles relating to negligent misstatement in Hedley Byrne v Heller[18] to this situation. Prima facie the relationship between the trustee of the pension fund and the employer as the ultimate funder of the defined benefit pension fund should fall within this special relationship for a negligence duty of care to arise.

8. The House of Lords' decision in White v Jones[19] held that a solicitor was liable in tort to a potential beneficiary under a will where the solicitor had negligently failed to prepare the will before the testator died.

9. This case is authority for the proposition that there was no need for reliance by the intended beneficiary on the person alleged to owe the duty of care.

10. A possible further line of argument is that the courts have held that there is an implied term in the Trust Deed of a pension fund that:

"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."[20]

Note: This implied term is also referred to as the "implied obligation of good faith".

11. It could be argued that a reciprocal obligation is owed by the trustee to the employer (although I have found no direct authority for this).

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17 Pitmans Trustees v The Telecommunications Group [2004] EWHC 181(Ch) at paragraph 56 (following previous authority) as to what the concept of "consultation" meant".

18 [1964] AC 465 (HL).

19 [1995] 2 AC 207 (HL).

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

PART IV

Management of legal risk in relation to defined contribution pension fund investment issues

H. Some preliminary issues in relation to defined contribution pension fund investments

1. In the UK, as noted in **Section E4** above, Section 33 of the Pensions Act 1995 prevents the trustee from excluding or limiting liability for breach of obligation under any rule of law to take care or exercise skill in the performance of any investment function.

2. Also as noted earlier, the 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"

   would suggest, in relation to a DC pension fund, that the trustee should, prima facie, consider whether the assets backing a particular member's retirement account are being appropriately invested having regard to the circumstances of the member.

3. Consider, for example, the member who may have had his retirement account balance invested for 20 years in the cash fund. It can be argued that the prudent person rule requires the trustee to intervene in this situation and to make alternative arrangements on the basis that investment for 20 years in a cash fund was not the type of investment an ordinary prudent person would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide.

4. Prior to 6th April, 1997 when Section 33 of the Pensions Act 1995 came into force, this problem was conventionally addressed through the use of an exclusion clause in the Trust Deed which protected the trustee so long as the trustee acted in good faith (even if negligent or acting in breach of the required trust law standard of care).

5. After 5th April, 1997 it also became uncertain as to whether the general grounds for absolving a trustee from liability where the member agreed to, or acquiesced in, the breach of trust by the trustee would still work (see **E3** above).

6. In the post-5th April, 1997 regime, the alternative approach is to look more carefully at the way in which the investment powers of the trustees are drafted.

7. For example, if the trustee may only invest the assets of the pension fund backing the member's retirement account in accordance with directions given by the member (and, in default, in a "hard coded" default fund), it is more

difficult under English law to assert that the trustee had acted in breach of duty if it had merely followed the member's instructions as it was required to do under the terms of the Trust Deed and had no discretion to do anything else.

8. This "duty defining" concept can also be applied when looking at the investment choices that are made available under the defined contribution pension fund.

9. If the trustee has the widest possible investment powers, then the starting position, under the prudent person rule, is that the trustee must:

- research the investment universe for suitable asset classes in which members' retirement accounts are to be invested,
- within each asset class, select one or more investment products with due skill and care,
- monitor the performance of the particular investment products, and
- de-select the investment product where it ceases to continue to be an appropriate investment.

10. One problem area which has emerged in the operation of a defined contribution pension fund in the UK is the reluctance by the trustee to de-select investment products which are under-performing.

11. Instead, members are informed that the trustee will not allow any new members to invest in those products and that members may wish to choose to inform the trustee to realise the part of those investment products linked to the member's retirement account.

Note: This has lead to something of a population explosion of under-performing investment products which are closed to new money but where the trustee has not sold the underperforming investments of non-responding members.

12. In this context, it should be noted that it is usual for UK pension fund Trust Deeds to require both trustee and employer consent for any amendments to be made (there are also certain restrictions on making amendments which adversely affect members' accrued rights).[21]

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[21] See Section 67 of the Pensions Act 1995 (to be amended in broadly equivalent terms from 6th April, 2006 by the Pensions Act 2004).

13. In some cases, insurance companies will offer a standard documentation package to employers along with an administration service and investment products for the establishment of a defined contribution pension fund.

14. The issue which then arises is whether, for example, if the charges under the investment product are not particularly appropriate[22], there is any liability on the part of the employer or the trustee for selecting an inappropriate investment product.

15. If the trustee has a wide power of investment and failed to go through the proper process of selecting the investments with the insurance company, then the answer is that the trustee would have acted in breach of duty and would have liability to compensate the member for loss sustained.[23]

I. Issues for lifestyle investment options

1. It is quite common in UK defined contribution pension funds for one of the investment options provided under the pension fund to be a "lifestyle" investment option.

2. In brief, a "lifestyle" investment option in the UK context usually works by investing the member's retirement account, when the member is younger, 100% in equity investments and, in a period starting 10 years or thereabouts before the member's chosen retirement age, the member's retirement account balance is switched gradually from 100% equity investments to 75% long dated bonds and 25% cash.

   Note: This particular asset allocation is based on the assumption that the member would buy an annuity with 75% of the retirement account balance and take 25% of his retirement account balance as a tax free cash lump (reflecting a conventional approach to taking retirement benefits in a DC pension fund, influenced by the fact that the maximum tax free cash lump sum would, typically, be 25% of the member's retirement account balance).

3. Problems which have arisen in this area in relation to lifestyle investment options include:

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[22] e.g. because there are cancellation charges if payments are not made for at least 5 years.

[23] See, for example, the Pensions Ombudsman's determination F00785 (10th November, 1998) in relation to the Peroe Systems Europe Retirement Benefit Scheme.

- clarity of explanation as to exactly how the switch from the equity investment phase to the long dated bonds/cash at the target retirement date works, and

- the presentation of the lifestyle investment option as being the default option to go for even though it may not be appropriate to the financial circumstances of the pension fund member.[24]

4. One of the issues which has not been adequately addressed, in my experience, in relation to investment booklets for UK DC pension funds is what happens to employer and member contributions which are invested during the switching phase.

5. Are they invested on a monthly basis in the same proportions as the asset allocation for the lifestyle fund for the year in question or are they used to rebalance the lifestyle fund back to benchmark if, as a result of market movements, the lifestyle investment fund is no longer invested in accordance with its benchmark?

6. There is often silence as to whether there is any obligation on the trustee or the lifestyle product provider to rebalance back to benchmark if, as a result of differential movements in the investment return on the different asset classes, the value during the year in question is out of alignment with the target asset allocation benchmark for that year.

7. Failure to have clear rules as to what is to happen in these situations and to communicate those clear rules to members would, in my view, leave a UK pension fund trustee exposed to claims from members.

8. A linked point is that, from 6th April, 2006, there will, for UK pension funds, be a number of different ways in which a member may take his benefits at retirement. In summary, the member would be able to consider the following 3 options:

- to apply all, or a minimum of 75%, of his retirement account balance to purchase an annuity for life,

- to take income drawdown (ie to drawdown his money purchase fund each year, within certain maximum and minimum parameters), or

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[24] See a paper by Professor Zvi Bodi (Professor of Finance at Boston University) published in the Financial Analyst Journal, May-June 1995, pages 18-22 which challenges the conventional "wisdom" that investors with long time horizons should invest more heavily in equities than investors with a short time horizon where this "wisdom" is based on the argument that the risks of equity investments diminishes with the length of your time horizon.

- to purchase, with part of his retirement account balance, a short term annuity of up to 5 years.

  Note: This new option is intended to allow the member to achieve certainty of income for an up to 5 year period without locking into the particular annuity pricing for long term annuities prevailing at the time of retirement, as well as recognising that, at older ages, the pooling of mortality risk leads to a higher annuity than at younger ages where the pooling effect of the mortality risk is less significant.

9. With those different choices available to members, this, in turn, raises issues as to the continued suitability of existing lifestyle investment designs for UK pension funds.

J. DC pension funds: issues relating to fees and expenses and the member's retirement account balance

1. It is common, in my experience, in the UK for a defined contribution pension fund to adopt the following approach in relation to fees and expenses:

   - the member's retirement account balance will bear the investment management fees and expenses charged by the investment product provider (which may also include an element for record keeping expenses), and

   - all other expenses are borne by the sponsoring employer.

2. Care is needed where the employer agrees to bear all of the other expenses to make sure that that agreement is only for a limited period and, if the employer no longer wishes to bear all of those other expenses (or, indeed, any of those other expenses), the employer can validly elect not to do so.

3. If such a right is not reserved to the employer (and, indeed, is not clearly communicated to members), 2 problems arise:

   - the first problem is that the employer could find that the level of expenses it is paying will, over time, be exceeded by the level of expenses it is paying in respect of former employees who are now deferred members (the so-called "deferred member population explosion problem"), and

   - if the employer wishes to wind up the defined contribution pension fund, he may find that the trustee has the right to call on the employer to make a payment equal to the present capital value of the future expenses into the fund in respect of the members whose retirement account benefits are to be secured on the winding up of the pension fund.

Comment: This figure here can be substantial (for example, if the annual expense charges are multiplied by 20 to give them a capitalised value).

4. In terms of managing this legal risk, an approach to follow could be:

   - to make sure that the Trust Deed of the pension fund clearly reserves the power to the sponsoring employer to discontinue payment of expenses for all or any members, and

   - to make sure that this right to require member's retirement accounts to bear expenses is clearly included in the member's booklet.

K. Timing issues in terms of investment/disinvestment of contributions to/payments out of a member's retirement account in a defined contribution pension fund

1. The starting position is to consider what would happen under general trust law rules if the Trust Deed is silent as to any particular time period within which contributions received could be invested or investments backing a member's retirement account should be disinvested to meet benefit payments or transfer payments.

2. This is proving a growing area for claims by members against the pension fund trustee.

3. For example, in one case:

   - a member's contributions were deducted from his salary on the 25th of the month, and

   - moneys were paid over by the pension fund to the investment product provider on the 5th of the following month.

4. The Pensions Ombudsman held in this case[25] that a delay of 10 days **(not working days)** between the deduction of contributions from the member's pay and their payment over to the pension fund for investment was an excessive delay giving rise to compensation for the member concerned.

5. Similar issues arise in relation to the time taken to disinvest a member's retirement account at the time when benefits come into payment where a transfer value is to be paid.

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[25] Mr. P.D.A. Nuthall: Determination G00543 dated 25th March, 1999 involving the Merrill Lynch (UK) Final Salary Plan.

6. If the Trust Deed is silent as to timings, then the starting presumption is that, in the UK, the amounts in question needed to be invested or disinvested within 5 days (in some cases, the position may turn on the dealing frequency for the investment vehicle in question).

7. Again, this is an issue which can be managed through appropriate drafting of the Trust Deed and appropriate statements in the member's booklet.

8. Under English law, it is better for the legal obligation to invest or disinvest to be based on a long stop date with no duty to do anything before the long stop date (but with, in practice, that period leading up to the long stop date being used to, in the normal course of things, implement the transaction on a timely basis.

9. It is also important to consider whether an express force majeure provision should be included in the Trust Deed (in my view, yes) in case problems arise in meeting the deadlines for investment/disinvestment as a result of matters outside the control of the trustee.

L. <u>Management of legal risk in DC fund member communications</u>

1. There is always an uneasy tension between:

   - the communications consultant writing the investment booklet for a DC pension fund, and

   - the lawyer trying to manage the legal risk of misrepresentation or material omission on behalf of the sponsoring employer and the pension fund trustee.

2. Here is what one communications specialist thinks:

   "*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.

3. There is a game that can be played between the views of the communications specialist as noted in **2** above and the views of the lawyer that the communications specialist:

   - only wants to tell the good news,

   - is unable to understand the legal relationships and risks, and

- likes to write in simple, unqualified, misleading, superficial, sentences which create considerable additional legal risk and liability for pension fund trustee and the sponsoring employer.

4. Claims arising from member communications tend to be based on 3 main grounds:

- negligent misstatement (ie a duty of care owed by the maker of the statement (the trustee or the employer) to the pension fund member on which the pension fund member relied)

- estoppel (which prevents the pension fund trustee or the employer from denying a state of affairs), or

- the incorporation of a statement into the contract of employment between the employer and the employee (giving rise to a claim for breach of contract).

5. In summary, in the case of "negligent misstatement", the tests are:

- was a duty of care owed by the maker of the statement to the recipient,

- is the statement incorrect, and

- did the member rely on that information to his detriment?

6. In terms of the measure of damages under English law for negligent misstatement, the position can be summarised as follows:

"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." [26]

7. In the case of estoppel by convention, the rule is as follows:

"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

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

allowed to go back on that assumption when it would be unfair or unjust to allow him to do so." [27]

8. As to whether the statement/misstatement has become incorporated into the member's contract of employment, the tests are:

   - is there an intention to create contractual relations,
   - has offer and acceptance occurred,
   - is there sufficient certainty, and
   - is there consideration (eg, in summary, something of value passing each way)?

9. If so, the member can claim damages for breach of contract.

10. There is a different measure of loss under a breach of contract claim (broadly the complainant is entitled to be compensated for not being in the position that he would have been in had the incorrect information been correct).

11. The "boilerplate" or disclaimer in the communications to employees can be effective to displace a duty of care or modify the duty of care in a negligence claim and also prevent the creation of a contractual relationship.

12. However as noted in **C5** above there are limits on how much protection disclaimers can provide.[28]

13. Looking at these issues, in the context of investment booklets for defined contribution pension funds, consider the following example:

   - the pension fund booklet had not explained clearly the circumstances in which the Trust Deed required the trustee to realise a member's retirement account,
   - the trustee was required by the Trust Deed to realise the member's retirement account because the investment produce was no longer within range of permitted investments, and

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

[28] See, for example, Hutchinson v. Steria Limited [2005] All ER (E) 352.

- the member sustained loss in the sense that the value of the member's retirement account was reduced as a result of early retirement charges.

14. The member argued that:

    - the trustee owed a duty of care to the member in compiling the booklet, and

    - the member, had he been aware of disinvestment penalties, would not have invested in that particular product.

15. The above are the facts, in summary, of a claim currently against a pension fund trustee (relating to the so-called "market value adjustment" applied by an insurance company to the realisation of a with profits insurance policy issued by the insurance company to the trustee of the pension fund).

16. Had this point been addressed in the Pension Fund Booklet, the trustee's position would be clear. It was not. So the defence turns on whether the disclaimer will work.

17. A suggestion for managing risk in this area is to try the following test:

    "In what circumstances is the statement not true?"

18. "True" for this purpose means legally accurate – the test which the courts and the Pensions Ombudsman apply.

19. It is sometimes said that truth to a person writing advertising material is an elastic concept. Some of you may also be familiar with the statement attributed to a senior British civil servant some years ago that he was not not telling the truth but being "economical with the truth".

20. Pension funds operate on long time horizons (decades rather than months). The longer the time horizon, the greater the possibility of a wide range of different outturns. This is a further reason for applying the "what if" test referred to in **17** above.

PART V

Conclusions

M. Concluding thoughts

1. Many defined benefit pension funds in the UK currently have substantial deficits.

2. This has placed pressure on the relationship between the trustee and the sponsoring employer. The previously aligned approach of jointly aiming to deliver a reasonable level of retirement benefit to pension fund members is under pressure with:

   - the trustee seeking to move to a higher level of funding and security for accrued benefits, reacting to a new funding and regulatory regime, leading to, on one analysis, the move into purchasing long dated government bonds at the top of the market, and

   - the sponsoring employer seeking to reduce pension costs through a combination of a less conservative investment strategy than that adopted by the trustee coupled with steps to change the benefit design of the scheme.

3. These pressures are increasingly bringing into focus the extent to which the trustee owes a duty to the sponsoring employer when investing the fund assets.

4. The duties owed by the trustee to the employer under English law in this area include:

   4.1 the clear duty to go through a meaningful consultation process in relation to the preparation and revision of the pension fund's statement of investment principles,

   4.2 a reasonably clear trust law duty to the sponsoring employer as the contingent or residual beneficiary under the pension fund (but with this duty being subservient to the duty owed to the members (and those in receipt of survivors' pensions of the pension fund), and

   4.3 potentially, but not yet established by any case law on the point of which I am aware, a duty of care owed to the employer when investing, given that the employer is the funder of last resort, not to invest in a recklessly conservative fashion nor to invest in a recklessly aggressive fashion, and

4.4 possibly, but yet to be established, an implied duty of good faith separate from the trust law duty to the sponsoring employer referred to in **4.2** above.

5. Defined contribution pension funds are relatively young in the UK. They do not give the sponsoring employer the funding risk which defined benefit pension funds give. But, they carry with them a completely different type of risk.

6. It is the risk of disappointment to the member in the level of retirement savings as a result, among other things, of:

- the level of contributions made,
- adverse investment performance,
- the impact of charges on the size of his retirement after allowing for investment performance, and
- the level of retirement income available when the member's retirement account is converted into a pension or annuity at retirement.

7. If the member is disappointed in the outturn, he will have time on his hands and the rest of his life to devote his energy to pursuing a claim against his former employer or the trustee of the pension fund.

8. It is easy for a pension fund member to litigate in the UK. The Pensions Ombudsman is available to investigate, for the price of a postage stamp, the member's claim.

9. This emphasises the need for careful management of legal risk in relation to the investment of defined contribution pension funds in the UK.

10. In my view management of this risk involves a combination of:

- a strategy of writing the pension fund trust deed in a manner which restricts the trustee's investment powers so that, by using a duty defining approach, the trustee's liability or potential liability to the member for not considering whether the member's investment instructions were appropriate is clearly displaced,
- clear wording in the Trust Deed as to the time limits within which contributions should be invested and retirement account balances disinvested,

  Note 1: These should be written as long stop dates with a force majeure provision rather than being over ambitious and leading to, usually the employer, making up the associated costs of the mistake.

Note 2: Well organised administration procedures and systems for dealing with the record keeping in relation to investments with a zero errors culture and approach is also a recommended approach (once an error is made in defined contribution pension fund investment administration, it becomes difficult to rectify the process).

- communication material which fairly and clearly describes the investment risk, the particular characteristics of the investment options and the charges applicable to the investment option.

11. By way of closing remark, perhaps a fitting response to the comments of the communication specialist referred to in **L2** above would be as follows:

> *"No man is above the law, not even the king."*[29] or even a communications specialist!

[29] Sir Edward Coke in relation to King Charles I.