1. Introduction

As the Trustee of what will become a large and complex DC scheme with a diverse membership, we’ve always interpreted our fiduciary duties as requiring a broad understanding of the financial interests of our beneficiaries over the long term. We’re aware of much narrower interpretations of these duties. We welcome both the aim of this consultation in seeking to draw out these debates and the clarification in the consultation document of the Law Commission’s interpretation of the duties.

We believe this is consistent with our own and maintains the exercise of trustee judgement as the basis of the law. While this openness to interpretation can also represent a challenge, we believe that it’s preferable to prescriptiveness and for this reason we’re not in favour of statutory codification.

In the light of these views, the bulk of our response seeks to engage with the specific questions and issues raised by the consultation. In some areas we argue that the view of the law in the consultation paper could be seen as too prescriptive, and suggest some trustees might rightly take a different view within the overall framework of beneficiaries’ financial interests. This shouldn’t be misread as disagreement with the broad thrust of the commission’s interim conclusions. The application of fiduciary duties in relation to pensions will evolve over time, so more debate is valuable and we believe this consultation is an important contribution to that.

In this spirit, we note two ongoing areas where this debate might focus over the coming months and years and which are perhaps at the frontier of where trustees might wish to continue to evolve the interpretation of the duties. These are:

1. We think there’s a need for a debate about the application of fiduciary duties to master trusts that runs wider than the use of the investment power. As a ‘master trust’, we have a set of responsibilities and obligations as a business that are ultimately funded through charges on members. All of our activities are overseen by a single governing body whose principal obligations are those derived from trust law. There’s a much more established debate about what this means in practice in relation to investment compared to other activities that we undertake. With the emergence of a growing ‘sector’ of master trusts within the UK corporate pensions sector we think the time is right for a conversation about how these trust-based businesses should be governed. How to apply a fiduciary framework in this kind of business is relatively uncharted territory. While out of the scope of this discussion, we flag it as a future area of enquiry for those in the field of trust-based pension provision.

2. The second issue we feel is due for further debate is how trustees should account for the interests of future members of a scheme. For new master-trusts the acquisition of new members will have a cost attached to it but the acquisition of those new members may contribute to the schemes’ ongoing viability. Similarly, later arriving members may benefit from others having covered start-up costs associated with the set-up of a master trust. There is little, if any, precedent available to trustees to help them trade off the issues raised here.

Fiduciary duties are our primary legal responsibility to our beneficiaries. We take a broad view of the best interests of the scheme membership and aspire to be a responsible investor. That broad view is aligned through evidence with the interests of the membership. In that spirit we welcome and support the Law Commission’s summary of the law. We feel that this provides welcome clarification in an area in which the case law is sparse, difficult and not always well understood. We hope that the Law Commission’s clear and welcome emphasis on the breadth and scope for trustee judgement in the law in this area sets a clear precedent for the diversity of acceptable considerations in the setting of a fiduciary’s investment strategy.
2. Context

Automatic enrolment has the potential to reshape pension provision in the UK. We think that master trusts: multi-employer trust based schemes will become an increasingly important part of the UK’s workplace pensions ecology. It is possible that the market will evolve to contain a small number of large providers. Indeed, the progress some master trust providers have made in enrolling new members in the last year suggests that is likely.

How these new, growing schemes manage the money they’re responsible for will have a major impact on the retirements of their beneficiaries. It will also have a significant impact on the companies they choose to invest in both at home and abroad. We believe that how the trustees of schemes exercise their judgement is likely to be a matter of public interest as much as it is for those concerned with outcomes for pension savers.

The impact of large institutional investors managing money with a long-term objective will be profoundly conditioned by the law. Given that reviews of this sort are extremely infrequent the settlement achieved by this consultation is likely to cover the emergence of whatever trust-based schemes automatic enrolment produces. Much of the case law relating to stewardship assumes that asset owners are only likely to have a marginal impact on the companies in which they invest. That may well end up not being the case as pension reform runs its course. What’s possible, desirable and effective for much larger trust-based organisation is likely to be very different to what’s sensible for smaller trust-based schemes.

3. Consultation response questions

3.1. Question 1. Do consultees agree that Chapter 10 represents a correct statement of the current law?

Yes, we believe that chapter 10 is a correct statement of the law as it stands. We don’t believe, though, that it’s a statement of the law as it’s always interpreted. However, there are many interpretations of the law. We’ve seen conservative interpretations of the law that emphasise the need to focus on quantifiable financial returns as the only real permissible criteria for decision making. We’ve also seen opinions, which we share, that stress the importance of taking the broadest range of factors into account when making investment decisions and the consistency of this with the duties.

We think it’s important that those considering what to take into account when making investment decisions within the framework of acting as a fiduciary, approach the matter from that perspective. We think this is important as good decision making here requires lawyers to understand investment matters and investment professionals to understand the law. Misunderstanding the nature of other professionals’ fields seems to us to be at the root of some of the difficulties we all face.

For example the concept of a ‘tie break’ as mentioned in the consultation, where two investments have identical risk and return credentials, but one may have a greater social value, is unhelpful both in theory and practice. Investment decisions don’t normally consist of a choice between two different securities with broadly similar risk return profiles and where a marginal factor tips the balance. We see this as a legal creation with no basis in good practice.

We don’t support codification of fiduciary duties in statute and note that the Law Commission doesn’t see this as required. We see the attraction in retaining the scope for trustee judgement that the law currently offers. However, the summary in chapter 10 is one of the most complete and useful summaries of the law we’ve seen. For this reason, we wonder whether it could function as the basis for a guidance document to be used as a reference for fiduciaries.

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

In responding to this question we’ve chosen to run through the issues outlined in chapter 10 of the consultation paper and comment on each in turn.
Financial outcomes as the primary focus for the scheme

We believe that risk must be taken into account in the search for return. Future outcomes are often inherently uncertain. Emphasis should be placed upon the drivers of outcomes such as savings levels, persistency of savings and the efficiency of transforming a capital value into an income.

Setting dynamic risk budgets

It’s sensible practice to control the level of risk present in any investment fund and to ensure that it’s suitable for the beneficiary - chiefly that it’s within their risk tolerance. As such, we at NEST are interested in risk adjusted return rather than the achievement of a speculative return regardless of risk. The 2005 investment regulations imply this through the emphasis on the ‘security’ of the portfolio.

NEST varies the risk budget of its target date funds for a variety of different reasons:

- to target cash/annuity prices at decumulation
- to control levels of risk within the funds in order to reduce the risk of a wide dispersion of outcomes for different cohorts of beneficiaries. The default funds forego potential upside in order to minimise the risk of catastrophic loss – in accordance with portfolio theory
- in a world where individuals can and do stop contributing due to interim loss we look to control volatility within the funds in order to prevent inexperienced investors panicking and stopping saving inappropriately.

The first two of these points is implicitly allowed for in the 2005 investment regulations, while the third is less clear cut. But in each of these cases the ultimate rationale for the risk budget is the financial interests of the beneficiary. In this instance their interests may well be in saving persistently, as with the third point above, as much as they are in achieving a decent return proportionate to the degree of risk taken.

We think that this illustrates the importance of a focus on the ultimate goal of the scheme, which is to provide a pension. It shows the importance of allowing trustee discretion in the achievement of that goal. Were it just to maximise returns then we might choose to set our objectives and risk budgets differently.

Stewardship

NEST Corporation’s current stewardship activities are modest but we intend to expand our activities over time in this area in proportion to our assets under management. This is because we see stewardship as being an important component of our long-term investment approach. In view of that, we’ve published a voting policy setting out principles for our future voting activity. These principles are tied back to evidence supporting the principle in question. For example we have a preference for diversity at board level as empirical evidence suggests that companies with diverse boards are more likely to succeed financially.

A simple cost/benefit analysis of this sort of activity is impossible. All that’s possible is to ensure that stewardship activity is tightly aligned to factors that should improve the value of the portfolio and to ensure that spending on stewardship activity is proportionate. The Law Commission is right to point out that this is easier for larger schemes, which may have greater resources. But there remain a number of options for smaller schemes and ShareAction point towards the services of third parties. These may be viable options for the trustees of smaller schemes that see stewardship as an important adjunct to investing.

There are points in the consultation paper where it’s implied that fiduciary duties aren’t the right way into some matters of public policy. We’d suggest that the effective functioning of companies, and the effective managing of properties and infrastructure projects aren’t solely a public policy issue, but are also a financial risk and return issue, and as such, a fiduciary issue. As alluded to earlier, ‘financial return’ isn’t a commodity but the product of complex human interaction and endeavour. Returns are generated on the basis of innovation, labour and the efficient allocation of capital. Pension funds and their trustees can and should take an interest in how and why returns are generated, and not just be passive recipients of what the market ‘delivers’. As such, we have considerable sympathy with some of the governance arguments outlined in the Kay review and don’t see how long-term value generation can be divorced from governance matters.
Wider factors aimed at securing financial returns

We aim to integrate environmental, social and governance risk factors into our investment decision making because they're an intrinsic part of what constitutes the price and long-term value of most securities. This is in our view noncontroversial - in the same way we factor things like credit and liquidity risk into decision making. We think it’s important not to create some sort of false hierarchy of financial factors and non-financial factors. Indeed the term ‘non-financial’ is unhelpful referring as it does to things that have financial impacts just not ones that conventional metrics capture.

We suspect that a lot of the confusion comes from the lack of understanding or clarity as to what ESG means and a conflation between ESG and ethical factors. This is not helped in our view by the requirement currently contained in the 2005 investment regulations, made under the Pensions Act 1995, encouraging trustees to determine what (if any) consideration trustees have given to social, environmental or ethical considerations. This SEE configuration is unhelpful in our view.

The policy intent of this piece of statute was, according to our understanding, to encourage trustees that considering broader aspects than short-term financial return is perfectly acceptable and indeed potentially beholden on trustees. Instead it appears to have had the opposite effect, and led to box ticking formality when preparing SIPs. We'd suggest that this could be an area of statute that would benefit from change. For example, elsewhere in the SIP requirements there's a section that encourages trustees to set out the different types of risk they factor in when making investment decisions. We'd suggest that ESG risks would be better placed here rather than the hiding in the current ‘socially responsible / ethical’ section of the SIP that the 2001 regulations carved out for them.

An additional practical and potentially statutory solution could be to require trustees to set out what their ‘investment beliefs’ are within their SIP. This is an approach that NEST Corporation and other larger trust-based schemes already use. The purpose of this would be twofold. Firstly the term ‘belief’ is particularly useful in putting to rest the myth that investment is a purely quantitative science, and that instead the exercise of judgement based on reasonable theory and empirical evidence is the best any investor can reasonably expect to do. And secondly that it allows trustees to have genuine strategic discussions about how they collectively believe financial markets operate and what sorts of strategies are most likely to achieve reasonable and repeatable results. This could be another area where debates around ESG can be held, and shown to be held, for the benefit of beneficiaries and other interested parties as to why certain decisions or paths are taken to the exclusion of others.

Wider economic issues

We welcome the Law Commission’s clarification that schemes are able to take macroeconomic issues into account. While schemes may have limited capacity to affect economic issues at the moment we shouldn't assume that will always be the case. As we noted in the introduction, there's a scenario in which automatic enrolment produces large, trust-based asset owners that have considerable influence. How those asset owners use that influence will be of considerable importance and will be shaped largely by trust law.

Quality of life factors

We welcome the Law Commission's view that quality of life considerations may be taken into account by trustees.

Ethical where unrelated to financial interests

We agree with the consultation paper that trustees should only consider ethical considerations in limited circumstances. We discuss this later in our response.
Fiduciary duty response

Beneficiaries’ views

We feel that the views of beneficiaries are important and have taken them into account when deciding whether and how we should offer ethical and Sharia funds. This was an important part of the process in setting up those aspects of the product. We feel that the approach set out in the consultation paper, which permits consultation but puts all decision making power and responsibility with the trustee is optimal. We see a democratic analogy as the difference between delegates and representatives. We favour the latter approach in this instance.

Fiduciary duty and the law

The consultation paper mentions, briefly, that trustees shouldn’t invest in activities that are unlawful and should abide by international conventions. We feel that the issues this raises are worth exploring further. At first sight, the recommendation that trustees refrain from investing in illegal activities is obvious. At second glance, it becomes clear that it’s difficult to put into practice without much more detailed clarification of terms. As this issue is dealt with only briefly towards the end of the paper, we feel that more debate and clarification could be helpful here.

3.3. Question 3. Do consultees think that the law is sufficiently certain? (14.15)

It seems to us that the consultation paper prizes the scope for trustee judgement over prescription. It makes a strong case for treating the law as a backstop to prevent flawed trustee decision making. In so doing, it avoids being prescriptive and avoids greater certainty about what trustees should be doing. We would welcome greater emphasis however on trustees being encouraged and indeed expected to take a broader view rather than affirming the legality of a narrow view, with the ability to go further.

The Kay review argued for something rather more than that, seeing fiduciary duties as a policy tool for the promotion of a more long-term, investor mind-set that focused more on stewardship and corporate governance. Plainly, more certainty in the law would be required to achieve that, along with further changes to the substance of the duties to make them more prescriptive.

We see lack of certainty as being a necessary part of the Law Commission’s interim conclusions. However, this implies a lack of acceptance of the conclusions of the Kay review – something that’s fundamentally a policy judgement. If that’s the case then the reasons for rejecting the Kay view should be worked through publicly – if not by the Law Commission then certainly by the Department for Business.

3.4. Question 4. Should the Occupational Pension Scheme (Investment) Regulations 2005 be extended to all trust-based pension schemes? (14.15)

We have no opinion on this issue.

3.5. Question 5. Are there any specific areas where the law would benefit from statutory clarification? (14.15)

We commented earlier in this document about the consideration of SEE factors in SIPs and also the potential inclusion of investment beliefs in SIPs. We believe that this area of the law would benefit from statutory revision.

3.6. Question 6. Do consultees agree that the law permits a sufficient diversity of strategies? (14.21)

We agree that the law as outlined in chapter 10 permits a sufficient diversity of strategies.

3.7. Question 7. Do consultees agree that the main pressures towards short-termism are not caused by the duty to invest in beneficiaries’ best interests? (14.24)

We have little first-hand evidence regarding the pressures towards short termism. Most beneficiaries are simply not engaged enough with fund performance to exert pressure on the scheme to change its approach. However, we’re frequently subject to requests from intermediaries for short-term performance data. As the NEST target date funds have only been operational for a short period of time this information, while interesting, has no evidential weight as far as investment decision making goes.
3.8. Question 8. Do consultees agree that the law is right to allow trustees to consider ethical issues only in limited circumstances? (14.28)

We noted earlier that we don’t see a conceptual distinction between ESG factors that may affect returns and other sorts of investment risk factors. In this response we’re purely discussing ethical factors that may involve something some people may find morally objectionable but might otherwise be a reasonable investment opportunity.

In this instance we feel that the consultation paper strikes the right balance. Where consideration of ethical issues would be expected to cause detriment to the portfolio, we believe there are only a limited set of circumstances under which it would be appropriate for trustees to take those issues into account. Trust-based pension schemes shouldn’t be a means through which trustees are able to advance personal ethical points of view. The sorts of scenarios where consideration of these issues may be appropriate should probably therefore be limited to when:

- the ethical issues in question raise consistency issues with the purpose of the trust
- the specific consent of the beneficiary has been given.

For example, the NEST scheme offers an ethical fund and a Sharia fund, both of which operate wide ranging ethical screens. But both are fund choices, rather than defaults, and as such require the member to actively select them.

Where there’s unlikely to be financial detriment to the portfolio we agree that trustees should have a freer hand – although still within the context of substantial constraint. The exclusion of limited numbers of stocks would have no material impact from a well-diversified portfolio, which means that clearing the first bar to taking ethical considerations into account should be possible in a limited number of cases. The second bar set out in paragraph 14.27 – confidence that members will share trustees’ outlook is more difficult to clear.

This is especially the case in a large multi-employer scheme such as NEST, which has a diverse membership. One obvious answer is to use the law as an expression of generally prevailing ethics, indeed this is implied in paragraph 14.25, which states that trustees shouldn’t invest in illegal activities. Similarly they shouldn’t invest in activities prohibited by international convention. If this means, as we believe it does, that UK law can be used as a filter for certain investment opportunities, then we think this issue should be discussed further. We note that it’s raised towards the end of the document and not in Chapter 10, which summarises the case law.

Otherwise, we think it’s worth discussing further how fiduciaries might understand beneficiaries’ ethical views better and how it might be appropriate to use beneficiaries’ views as a reference point. Even within particular interest groups there’s rarely unanimity of view, indeed Harries vs. Church Commissioners arose from a difference of opinion within a section of the Church of England. The salient question for multi-employer schemes is how far unanimity of view is required in a diverse population in order to take an ethical stance? If 95 per cent of beneficiaries are opposed to an investment with the remainder neutral is that sufficient? Given that schemes may find themselves subject to pressure on these sorts of issues, now and in the future, we feel that further discussion here is merited.


We sympathise with the Kay review’s conception of investment. At the risk of caricature, the review’s ideal investor is something approaching Berkshire Hathaway, which is in turn closer to a private equity fund in conception and execution than it is to a typical actively managed approach. Berkshire Hathaway invests in quite a small number (fewer than 50) predominantly blue chip companies. Buffet and his colleague Charlie Munger argue that it’s better to invest in a small number of firms with which they’re intimately familiar than spread their capital more widely.

For us, though, Berkshire Hathaway is the exception that proves the rule. Clearly there are only a handful of individuals and organisations with that sort of track record. It doesn’t make sense for a Scheme such as NEST to attempt to emulate such an unusual and sophisticated investor. Schemes such as NEST have to take advantage of the strategies that are realistically open to us, which are still potentially very high quality. In our view, attempting to capture economic growth across a wide range of geographies and asset classes is not only a legitimate strategy but also one of the most sensible possible approaches to the problem. We believe that this is consistent with the law but is not actually encouraged by it. In other words, we didn’t do what we did because of the law, we did it because we thought it the best way to match resources to the desired objective.
In that spirit, we don’t really recognise the term ‘excessive diversification’. Diversification poses challenges – specifically the greater the degree of diversification the harder it is to act as an engaged investor. But these are issues to be worked around to the greatest extent possible, not fundamental impediments to the kernel of a sensible strategy.

3.10. Question 10. Does the law encourage trustees to achieve the right balance of risk and return? (14.32)

We believe that it’s possible to encourage the right balance of risk and return within the law but that the role of the law in encouraging this balance is, in practice, limited. We note that ‘best interests’ or ‘best financial interests’ could be construed as implying a good balance between risk and return but that a trustee needs to go through several steps of reasoning before arriving at that conclusion. In other words, the law can be construed as pointing in the right direction but it offers a somewhat general signpost.

3.11. Question 11. Are there any systemic areas of trustees’ investment strategies which pose undue risks? (14.32)

We don’t believe that any area of our investment strategy poses undue risks and can’t comment about the strategies of others. We don’t believe that fiduciary duties encourage investment approaches that are, in some way, systematically deficient. Our concerns here relate less to the legal framework and more towards other pressures on trustees.

3.12. Question 12. Overall, do consultees think that the legal obligations on trustees are conducive to investment strategies in the best interests of the ultimate beneficiaries? (14.33)

Subject to the qualifying comments we make in preceding sections we believe that the legal obligations on trustees are conducive to investment strategies in the best interests of beneficiaries.

3.13. Question 13. If not, what specifically needs to be changed? (14.33)

We think that fiduciary duties, as interpreted by the Law Commission in chapter 10 of the paper are conducive to good investment strategies.

We feel that the tie-break principle isn’t a useful decision-making principle. However, we don’t think it’s worth attempting statutory codification to resolve this particular issue.

3.14. Question 14. Do consultees agree that the duties on contract-based pension providers to act in the interests of scheme members should be clarified and strengthened? (14.42)

We think that clarifying and strengthening the governance of contract-based schemes will have a positive impact on the market as a whole. It seems clear though, that contract-based providers or new governance committees can’t be held to a fiduciary standard. The duty of loyalty is inappropriate where there are other potentially competing and entirely legitimate duties – such as those to shareholders.

As such, we feel that a new, lower bar will need to be created and a new mechanism devised for trading off the different legitimate interests present within contract-based providers.

3.15. Question 15. Should specific duties be placed on pension providers to review the suitability of investment strategies over time? If so, how often should these reviews take place? (14.42)

We think that the periodic review of the suitability of an investment strategy is critical to the delivery of a good financial outcome for beneficiaries. In some cases in the NEST scheme we anticipate investing over quite long term horizons, likely in excess of 45 years for a minority of members. It’s inconceivable that we wouldn’t want to alter the strategy over that period of time. It’s also unlikely that our beneficiaries, if it were exclusively up to them, would make expert investment choices over that time period.

This gets us quickly to the heart of the issue, which is that contract and trust-based occupational products will be perceived by the end customer as fundamentally similar, if not the same. It makes no sense from the point of view of creating a functioning market if one product set requires a whole different level of knowledge and engagement in order to deliver a good outcome. Specifically we expect customers to arrive at retirement with both trust and contract-based products in their retirement portfolio as a result of having no real choice over their employer’s choice of pension scheme. The likelihood is that the contract-based elements of their portfolio won’t have been updated at all since enrolment, as things stand and based on what we know about levels of engagement with fund choice.
As most customers will see these as identical products we believe that default funds should function in similar ways whether in the contract or trust-based sector. At the minimum this means ensuring that they ‘keep themselves current’.

Clearly there are issues with the application of this line of reasoning to legacy business in terms of the barriers created by contract law. The barriers for business written in the future, though, look much lower.

3.16. Question 16. Should members of Independent Governance Committees be subject to explicit legal duties to act in the interests of scheme members? (14.42)

We don’t feel that we should go further than our answer to question 14 in responding on this issue.

3.17. Question 17. Should pension providers be obliged to indemnify members of Independent Governance Committees for liabilities incurred in the course of their duties? (14.42)

We don’t see how the proposed governance committees could function without providers indemnifying the members.

3.18. Question 18. Do consultees agree that the general law of fiduciary duties should not be reformed by statute? (14.61)

We agree that statutory codification isn’t required and accept that to do so would reduce the scope for the exercise of judgement currently offered by the law. We feel that as successive reviews have found uncertainty in the way that the law is applied – if only second hand – and that much of the audience applying the law in practice are not lawyers that there are alternatives short of statutory clarification that might be beneficial. We feel that the relevant department could issue a policy document clarifying the law and including worked examples – such as the Law Commission has produced for this consultation. We feel also that TPR could issue a similar document to trust-based pension providers.


We have no response to make.

Question 20. Is there a need to review the regulation of investment consultants? (14.71)

We have no response to make.

Question 21. Is there a need to review the law of intermediated shareholdings? (14.74)

We have no response to make.

Question 22. Should the FCA review the regulation of stock lending by custodians? (14.75)

We have no response to make.