Feature

KEY POINTS

- In light of the Kay Review, the Law Commission opened a consultation in October 2013 in terms laid out in a consultation paper entitled "Fiduciary Duties of Investment Intermediaries".
- It might be possible to compel trustees and their investment managers to support long-termism...but that is contrary to the freedom to define investment policy and investment granted to trustees by trust legislation.
- It would seem that a small modification to the law as it stands could not even begin to lead to the outcome which the Kay Review explains is desirable for UK companies.

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Disloyalty in the UK capital markets: investment intermediaries and fiduciary duties

This paper contains a brief discussion of the connection between investment intermediaries (in particular, investment managers), the investment duties of trustees and the objective of encouraging long-term investment in UK capital markets. It concludes that the objective of harnessing investment intermediaries with fiduciary duties to this end is a matter for the contracting parties.

In June 2011, the Secretary of State for Business, Innovation and Skills asked a leading economist, Professor John Kay, to review whether equity markets in the UK give sufficient support to the key objective of developing the business of British companies. Professor Kay published his final report in July 2012. It is entitled the "Kay Review of UK Equity Markets and Long-term Decision Making" and concludes that decisions to buy and sell shares in the public equity markets are too often taken to fulfil short-term objectives, whereas long-term objectives are in the interests of the ultimate beneficial owners of the shares and the companies which have issued them.

The Kay Review:

- identified that often the decision to buy and sell shares is taken for and on behalf of those who have an economic interest in the results. This is true in every case in which discretion to trade has been conferred by an owner on an investment manager. Sometimes the interested person decides which manager to instruct, how he should be rewarded, how much risk he may take and what guidelines he should follow. Often these decisions are taken, not by the interested person, but by others, typically trustees, who must follow rules when they decide whether to confer a mandate on an agent to deal in the assets of which the fund in their care is comprised; and
- observed that the use of intermediaries means there is often no direct connection or relationship between the person with an economic interest in the value of a share and the company by which the shares were issued. For example, the trustees of a pension fund might employ someone to help them formulate a suitable investment policy, to identify a custodian (bank) to hold the trust assets which might have title to the shares via sub-custodians, and an investment manager to trade the assets. In turn, the investment manager might engage other professionals to assist in the execution of trades or in exercising voting rights attaching to the shares.

An important premise of the review is that the "long-termism" is good for companies and shareholders and "short-termism" is bad. These phrases are well established in the law and economics of corporate governance and are shorthand for describing the complex issues surrounding how the decisions which the managers of a public company take are influenced by the capital markets, including the equity markets in which its shares are traded and in which it might seek to raise more money from time to time.

WHAT IS LONG-TERMISM?

In simple terms, the idea behind long-termism is that if a sufficient number of the shareholders of a company believe that it is more likely to prosper when its managers are able to take a long-term view about how its resources are allocated, they will keep their shares for a long time and use their powers so as to enable the managers to deploy its resources to achieve and sustain prosperity in the long-term. If that happens, it will be more likely that the value of the shares will increase, that dividends will be declared and that the shareholders will become richer. The long-term allocation of resources would include, for example, investment in plant and machinery, product development and training.

Thus, long-termism is the belief that a company is more likely to achieve prosperity if it has a stable body of shareholders who successfully encourage its managers to take a long-term view. Its proponents include, for example, the large companies which support adherence by institutional investors and companies to the Aspen Institute's guiding principles for obtaining long-term value creation (www.aspeninstitute.org). Those principles require a company to publish information about its business that demonstrates its long-term prospects and by making sure that the managers who work for the shareholders and those who work for the companies invested in, are rewarded for creating value in the long-term: ideas that

find expression under the rubrics "metrics", "communication" and "compensation". The Aspen Institute says that short-termism refers to the excessive short-term pressures in today's capital markets that result from intense focus on quarterly earnings and incentive structures that encourage corporations and investors to pursue short-term gain with inadequate regard to long-term effects.

The Kay Review (naturally) proceeds on the assumption that because long-termism is a good thing for savers and companies then it is a goal shared by the members of each class. However, says the review, the intermediaries who have the power to decide when to buy and sell and vote shares are too often able to obtain personal rewards from taking a short-term view, and do so. This is to the detriment not only of those with an economic interest in the shares but also the companies that have issued the shares. In other words, this reasoning leads to the conclusion that the behaviour of the intermediaries is selfish and, in essence, disloyal. In this sense it is disloyal because it can be said that the intermediaries are acting primarily in their own interests and not the interests of the ultimate economic beneficiaries for whose benefit they have been employed.

In this way, the Kay Review concluded that the goals of the intermediaries often do not match the long-term goals shared by the person with an economic interest in the shares and the companies by which these were issued. If the premise and conclusion in the Kay Review are correct then the key question for consideration is what (if anything) can be done to change the behaviour of the members of the investment chain so that "long-termism" is promoted. If there is anything that can be done, the question arises whether or not it should be done – which is a political and not a legal question.

FIDUCIARY STANDARDS

In the quest for a way to influence the behaviour of investment intermediaries, the Kay Review focused on a group of ideas which it described with the phrase "fiduciary standards", meaning that:

> "All participants in the equity investment chain should observe fiduciary standards in their relationships with their clients and customers. Fiduciary standards require that the client's interests are put first, that conflict of interest should be avoided, and that the direct and indirect costs of services provided should be reasonable and disclosed. These standards should not require, nor even permit, the agent to depart from generally prevailing standards of decent behaviour. Contractual terms should not claim to override these standards."

Professor Kay was obviously cognisant that, while this group of ideas is quite closely related to what fiduciary duties imply and entail in law, it does not (necessarily) match the legal meaning. Quite apart from this, he noted that there is confusion, in particular on the part of some asset managers, about when they are under fiduciary duties, and, when they are, how that should regulate their conduct: and called for clarification about this from the Law Commission.

THE LAW COMMISSION'S CONSULTATION

Accordingly, in the light of the Kay Review, the Department for Business, Innovation and Skills and the Department for Work and Pensions has asked the Law Commission to conduct an investigation, which is (in broad terms) mainly into how far the law of fiduciary duties applies to investment intermediaries and to evaluate whether it works in the interests of end investors. The Law Commission opened a consultation in October 2013 in terms laid out in a consultation paper entitled "Fiduciary Duties of Investment Intermediaries" (Law Comm. 215).

Using evidence from the Office for National Statistics (the best available), the consultation paper explains who invests in UK equities and says that even though many of these investors are now foreign, it proposes to focus on UK pension funds because these are governed by English law and are a crucial investment for many people in the UK who are vulnerable to failures in the financial markets. Moreover, the consultation paper notes the evidence shows that while pension funds in the UK now invest a lot of value in foreign equities and less in UK equities than before, they remain large investors in UK equities.

Many pension schemes are structured as trusts; some are governed by statutory instruments, and an increasing number are based on contract and are typically provided by insurance companies. Under trust based schemes, there is a fund into which companies and their staff make payments, which in equity belongs to the beneficiaries under the scheme and is administered on their behalf by trustees. Under contract-based schemes, the insurer makes no more than a promise to pay out in consideration of payments it has received: once the money has been paid to the insurer it belongs to it absolutely, although the insurer ought to maintain a fund of assets to ensure it is able to meet its liabilities as these fall due. Therefore, precisely how funds in contract-based schemes are managed is a matter for the insurer, obviously within the confines of any applicable regulations.

The consultation paper identifies the members of the investment chain and notes that if there are any trustees, then beyond them, the members of the chain are by and large the same for any other person making investments in equities, in particular, if they engage an investment manager. The consultation paper focuses on trustees and, in particular, on pension trustees: firstly, because the performance by trustees of their investment functions is susceptible to discussion and analysis as a matter of law; and, secondly, because even though trust-based pension schemes may be less popular now than before, a very considerable value continues to be invested through these for the benefit of people in the UK, including in UK equities.

FIDUCIARY DUTIES

By the middle of the 19th century it was well recognised that courts of equity could

undo transactions that would otherwise be permitted to stand, only because there was a peculiar relationship of trust and confidence reposed by one party in the other, between, for example, a solicitor and his client or an agent and his principal. The courts would closely scrutinise what had occurred and would undo the transaction if it was not satisfied that the principal had given fully informed consent which s/he might be taken not to have given if the fiduciary had not given adequate disclosure to the principal: see, eg, the detailed discussion in *Commentaries on Equity Jurisprudence*, Joseph Story (10th Edn, 1870). These transactions typically involved a conflict between the duty the fiduciary owed the principal and either his own interest (interest and duty) or the duty owned to another person (duty and duty).

It was always accepted that the categories of person who could benefit from this kind of protection from courts of equity could be expanded and, in due course, duties owed by trustees to beneficiaries came by analogy to be recognised as owed by fiduciaries to principals and accordingly concomitant remedies were granted. Thus, in the later 19th century it was held that the promoters of a company, formed to acquire and work a particular asset (such as a mine), stood in a fiduciary relation to their shareholders. Therefore, the shareholders could obtain an order requiring the promoter to disgorge to the company profits he had secretly made from the acquisition by the company of that asset. The basis for this was that the promoter was in a "trustee like" position and held the profits on trust for the company: eg, *Erlanger v New Sombrero Phosphate Company* (1878) 3 App Cas 1218.

The main remedy for compensation claims against trustees is the action for an account which had been adopted by the courts of equity from the common law before the 18th century. It is a claim for the trustee to admit what he has received to hold it on trust for the trust and explain what he has done with it, and what property he would have so received, but for his neglect. For example, as to receipts, a trustee who had received a secret commission on the sale of trust property to a third party would be obliged to enter it in his account as a receipt, no matter at what price the property was sold. In *Erlanger*, once it had been recognised that the fiduciary promoter was holding his profits on trust for the company, he was obliged to account for this as a receipt.

The negligence aspect of the claim for an account concerns the standard to which the trustee is bound to perform his duties for which the standard is reasonable skill and care in pension trusts. That is also the default standard in private trusts. Equitable compensation for breach of the duty of skill and care resembles common law damages in that it is awarded by way of compensation to the plaintiff for his loss. There is no reason in principle why the common law rules of causation, remoteness of damage and measure of damages should not be applied by analogy in such a case. It should not be confused with equitable compensation for breach of fiduciary duty: *Bristol and West Building Society v Mothew (t/a Stapley & Co)* [1998] Ch 1.

Often claims for compensation against fiduciary office holders are not closely connected with the duties they owe as fiduciaries: mere incompetence is not enough for breach of fiduciary duty, there must be disloyalty. For a long time there was a tendency on the part of lawyers to confuse these claims, but it is now clear beyond doubt that the duties of skill and care are separate from fiduciary duties, in particular because of the judgment of Millett LJ in *Mothew* who said [at 18], that:

> "A fiduciary is someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence. The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary. This core liability has several facets. A fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal. This is not intended to be an exhaustive list, but it is sufficient to indicate the nature of fiduciary obligations. They are the defining characteristics of the fiduciary. As Dr Finn pointed out in his classic work *Fiduciary Obligations* (1977), p 2, he is not subject to fiduciary obligations because he is a fiduciary; it is because he is subject to them that he is a fiduciary."

Moreover, a fiduciary who deals with his principal must prove affirmatively that the transaction is fair and that, in the course of the negotiations, he made full disclosure of all facts material to the transaction. Even inadvertent failure to disclose will entitle the principal to rescind the transaction. The rule is the same whether the fiduciary is acting on his own behalf or on behalf of another: eg, *Moody v Cox and Hatt* [1917] 2 Ch 71 (CA).

In certain relatively unusual situations, where a breach of fiduciary duty has caused loss which cannot be compensated by a money order upon the taking of an account or in common law damages, the court may order compensation to be paid that is akin to damages: see, eg, the discussion in *Swindle v Harrison* [1997] 4 All ER 705 (CA) although it has been said that the basis for these money claims needs to be worked out: see generally, *Fiduciary Loyalty*, Matthew Conaglen (1st Edn, 2010 at 85-96).

FIDUCIARY DUTIES AND CONTRACT

At the start of this short summary of fiduciary duties, it was observed that the original jurisdiction equity exercised was to undo transactions that would not otherwise have been undone. The court's willingness to undo the transactions depended on the peculiar relationship of trust and confidence between the parties: such a relationship is not easily found. In rather crude terms: a person might enter into a contract because he has trust and confidence in the counterparty, but this has nothing to do with what the counterparty is obliged to disclose to him.

Biog box

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There is no peculiar relationship of trust and confidence – in short, freedom to contract for personal advantage is a central tenet of English law and will not be lightly disturbed by the courts.

Nevertheless, fiduciary duties may subsist between contracting parties (eg, agents and their principals) but the courts are very cautious about acknowledging the presence of such duties and will do so only on a fact sensitive examination. Where parties have entered into a contract and there are fiduciary duties, then their content may have to be moulded and informed by the terms of the contractual relationship: see *Hilton v Barker Booth & Eastwood* [2005] 1 WLR 567 per Lord Walker [at 30]; also, *Hospital Products Ltd v United States Surgical Corpn* (1984) 156 CLR 41 per Mason J at 97 (the fiduciary relationship if it is to exist at all must accommodate itself to the terms of the contract). Where contracting parties are in doubt about whether or not fiduciary duties may arise on the terms of the relationship, they are free to agree that these should be included or excluded or confined.

The Law Commission's consultation paper contains a clear explanation of fiduciary duties insofar as these affect trustees and other members in the investment chain. In broad terms, it concludes that even though the law is in some respects open to doubt the principles are tolerably clear and that some of the doubts exist because the law of fiduciary duties is flexible and the results it produces are fact specific. The law of fiduciary powers, which is also treated in the consultation paper, is well settled. However, interesting questions arise where fiduciaries delegate their investment management discretions to investment managers.

TRUSTEES AND INVESTMENT MANAGERS

Pension trustees and normally the trustees of private express trusts have a power to invest as if they were the absolute beneficial owners of the assets. The selection of trust investments is a fiduciary discretion (*Rowland v Witherden* (1851) 3 Mac & G, 574). Trustees may delegate the selection of actual trust investments to an investment manager unless the terms of the trust expressly prohibit this. However, they must be careful about who they select and the terms of engagement, that the instructions they give the investment manager about how much risk they may expose the portfolio to are appropriate to the needs of the trust, which asset classes he may invest in and whether or not he may engage in, for example, borrowing and if so to what extent and for which purposes. Provided that the trustees discharge these duties with due care, they are not liable to indemnify the trust fund for any losses that might arise from the investment manager's breach of duty.

When the investment manager negotiates with trustees they stand in the same position as any other client. A duty of care and skill may never be excluded; however, in private trusts, the test for whether or not the duty has been discharged may be modified from an objective standard or prudence to a subject standard of dishonesty (see *Armitage v Nurse* [1998] Ch 241). If the investment manager is aware (as he should be) that trustees' powers of investment have delegated to him, then he too will be a fiduciary in respect of the exercise of those powers. Even though the investment manager is not strictly speaking a trustee because he is not a custodian of trust property he is, by way of delegation, carrying on a fiduciary function: in principle, therefore, it is hard to see why he could not by analogy be capable of being placed under the same duties as a trustee, except to the extent that the trustees are authorised by the terms of their trust to exclude or limit the investment manager's duties. However, the main point is that the trustees control whether or not to contract and if so on what terms, and all parties are able to obtain legal advice about the implications of what they want to agree to.

COMMENT ON INVESTMENT THEORY

Trustees are under a duty to diversify the investment portfolio. Full diversification is said to occur when portfolio theory is used. Portfolio theory is a method of analysis that relies on statistics. It does not ask or explain why values are or are not correlated. It identifies only that this is so. It might be thought there is diversification when the investor has bought shares of equivalent value in both a gold mining company and a brewer because the value of the shares in one is not likely to be affected by the same events that affect the value of the other since each is in a different sort of business: however, statistical analysis might demonstrate that (for unknown reasons) there is a positive or negative correlation between these shares. Thus, correlation between the shares in the miner and the brewer might be near zero, but the reasons why are irrelevant.

Professor Kay identified portfolio theory as a problem: obviously, at its most extreme, the investment manager pays relatively little attention to the values of "long termism". Trustees, who might be unsophisticated investors apt to be influenced by investment managers about ideas such as portfolio theory, may therefore fail to appreciate the benefits of "long-termism". It might be possible to compel trustees and their investment managers to support long-termism by requiring trustees to invest a certain proportion of their value in specified equities, but that is contrary to the freedom to define investment policy and investments granted to trustees by trust legislation. Moreover, there are no such controls where increasingly popular contract based pensions are in play.

CONCLUSION

"Fiduciary standards" exist in the market for investment services concerning UK equities, sometimes in the form of duties of skill and care and sometimes in the form of fiduciary powers and duties. However, it is hard to see how the idea of "long-termism" can be propagated in the UK equity markets by trustees, unless they choose to see its benefits; which they might only do if they are compelled to. However, (it appears) that their influence, while still quite substantial, is diminishing. It would seem that a small modification to the law as it stands could not even begin to lead to the outcome which the Kay Review explains is desirable for UK companies: if the theories in the Kay Review are correct, perhaps some different and possibly more radical change is needed. ■