UNISON Scotland

Pensions Briefing – September2015

Fiduciary Duty

Introduction

The precise nature of fiduciary duty in relation to the Scottish LGPS has become a topical issue in recent years. Primarily in relation to investment decisions and the degree to which fiduciary duty acts as a constraint on certain investments (e.g. infrastructure and local investments), and more broadly when considering Environmental, Social and Governance issues (ESG).

The Scottish Local Government Pension Scheme Advisory Board has decided to seek a legal opinion to inform new guidance for pension boards. This briefing sets out some interim advice for UNISON representatives on pension boards and elsewhere.

What is a Fiduciary Duty?

The classic definition of fiduciary duty in Scots Law is one under which as a matter of law a party (the fiduciary) is bound to prefer to his own interests those of another (the principal or beneficiary), for whose benefit he is exercising particular powers or undertaking particular transactions. This is in contrast to normal transactions, in which each party considers their own interests.

It derives from the law of trusts, but can apply wherever one party is entrusted with powers for the benefit of another in circumstances when the beneficiary has a reasonable expectation that its interests will be given priority. Pensions are an obvious application of this even though, unlike many private sector pension schemes, the fiduciary in the SLGPS is not a formal trustee. This is because the SLGPS is a statutory scheme rather than a trust based scheme.

Both the Scottish Law Commission (SLC) and the Law Commission of England and Wales (LCEW) have examined the issue of fiduciary duties, although neither has looked specifically at the issue as it concerns the Local Government Pension Schemes. The SLC examined the issue within the context of trust law; whilst the LCEW looked at the issue from the perspective of private sector pensions.

In March 2014 the LGA instructed counsel opinion on this and related issues from Nigel Griffin QC. This opinion is obviously under English law and predates the new governance arrangements. He took the view that the administering authority does owe fiduciary duties, both to the scheme employers and to the scheme members. He states that fiduciary duties are not limited to trustees and an LGPS fund is closely analogous to a trust fund.

Application of a Fiduciary Duty

Prior to the Public Service Pensions Act 2013 it was sometimes argued that because the defined benefits require to be paid regardless of fund performance, it was only employers that suffered any financial impact. However, as Nigel Griffin QC puts it; *"it would be naïve to suggest that there is no scope for members to be affected by fund performance. If the fund is doing badly, and employer contributions rise as a result, it is easy to see that the various discretions for which the 2013 Regulations provide are less likely to be exercised in members' favour. Further, as a practical proposition, if the fund is running into severe financial problems and employer contributions threaten to reach unsustainable levels, legislative measures are likely to be taken to curtail benefits or raise employee contributions well before the point of exhausting the fund is reached, regardless of what the position might be if such exhaustion actually occurred".*

The 2013 Act provides for an employer cost cap that could result in an increase in employee contributions. In addition, increasing employer contributions could create further budgetary pressures on employers with a consequential impact on members pay, conditions and job security.

As far as investment decisions are concerned it has been common practice to refer to Martin v City of Edinburgh Council 1988 (investment in South Africa in Apartheid era) and the well known English case of *Cowan v Scargill 1985* in which the NUM sought to direct the investment strategy of the NCB pension fund. In that case the court said; '*the best interests of the beneficiaries are normally their best financial interests*.'

However, this was implicitly doubted in *Harries v The Church Commissioners for England* which held that trustees are entitled to consider the social and moral interests of the beneficiaries where they relate to the express or implied objects of the trust. The *Goode Report* on *Pension Law Reform* in 1993 stated the law to be that trustees; "*are perfectly entitled to have a policy on ethical investment and to pursue that policy, so long as they treat the interests of the beneficiaries as paramount and the investment policy is consistent with the standards of care and prudence required by law*". In 2014, the Law Commission (England and Wales) commented that the case should not be seen as precluding pension trustees from taking account of environmental, social and governance factors when making investments. This followed the Kay Review, which was critical of short termism in investment decisions by some pension trustees.

In the LGA opinion, Nigel Griffin QC concluded; "*The administering authority's power of investment must be exercised for investment purposes, and not for any wider purposes. Investment decisions must therefore be directed towards achieving a wide variety of suitable investments, and to what is best for the financial position of the fund (balancing risk and return in the normal way).*
However, so long as that remains true, the precise choice of investment may be influenced by wider social, ethical or environmental considerations, so long as that does not risk material financial detriment to the fund. In taking account of any such considerations, the administering authority may not prefer its own particular interests to those of other scheme employers, and should not seek to impose its particular views where those would not be widely shared by scheme employers and members (nor may other scheme employers impose their views upon the administering authority)."

Financial and non-financial ethical issues are not always easily separated. For example, investment in fossil fuels could be financially impacted by international action on climate change or risks associated with what is known as the 'carbon bubble'. The Wellcome Trust's investments in fossil fuel companies have lost an estimated £175m in the last year, due to sharp falls in share prices. This shows that there is a financial, not just a moral, case for divestment.

Under Scots law, a challenge to the exercise of fiduciary power by trustees is possible under the common law on the following grounds: consideration by the trustees of the wrong question; a failure of the trustees to apply their minds to the right question; the trustees' perversely shutting their eyes to the facts; or trustees' failure to act honestly or in good faith. These grounds are influenced by the law concerning judicial review of administrative action, and are somewhat more comprehensive than those recognised in England. The Scottish Law Commission has also consulted on a suggestion that a statutory right to challenge the exercise of fiduciary powers should be granted.

Too restrictive a view of fiduciary duty not only impacts on ESG issues. The Law Commission of England and Wales also identified a possible range of other behaviours that could impact unfavourably on pension funds. For example, funds may attempt to protect themselves against criticism by doing the same as everyone else – known as lemming or herd behaviour. As Lord Myners, Financial Services Secretary to the U.K. Treasury, said in 2010; *"in this world, it is fine to be wrong or even lose money, as long as you do so in the company of others*".

Public Law Duties

Public bodies are generally creatures of statute and have a range of duties imposed on them by legislation. The extent to which these duties impact on the investment decisions of the administering authority has been given only limited consideration. For example, local authorities have a duty to cut carbon emissions under the Climate Change (S) Act. It is therefore arguably a factor the pension fund needs to consider when making investments in the fossil fuel and similar industries.

On this point Nigel Griffin QC concluded that; *"In managing an LGPS fund, the administering authority has both fiduciary duties and public law duties (which are in practice likely to come to much the same thing)."*

In 2003 the European Union set out a prudential framework for pensions known as the Institutions for Occupational Retirement Provision (IORP). The objective of the IORP Directive is to provide a prudential framework for pension funds based on minimum harmonisation and mutual recognition. To achieve this objective the Directive sets out a number of requirements on pension funds.

Both UNISON and the LGA sought counsel opinion on the applicability of IORP to the LGPS. Both opinions concur that IORP applies to the LGPS, although they differed somewhat on the implications of IORP for the current structure of LGPS funds. However, these differences are probably more relevant to the SAB work plan review of the fund structures.

Conclusion

Pension managers and advisors are generally cautious individuals, comfortable with the traditional view of fiduciary duty as set out in the Scargill case. Reports to pension committees and boards often reflect this position and discourage the modern interpretation. In an era when members are increasingly concerned about where their money is being invested and growing interest in the use of pension funds to benefit the Scottish economy, it is important that fiduciary duty is not exaggerated as a constraint on better investment.

While this briefing has focused on fiduciary duty in relation to investment, it also applies to ensuring best value. External advisors are less keen on transparency in relation to their transaction costs! We will be issuing further guidance on this point.

As can be seen above, pension funds are entitled to take environmental and social issues into account. In addition pension funds are not exempt from the public law duties that apply to the administering authorities. All investments involve a degree of risk, so fiduciary duty doesn't mean taking no risks. Ethical investment is rarely any more risky than other investments and legal challenges are rare so long as funds follow a proper process.

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Further Reading

Law Commission (E&W): Fiduciary Duties of Investment Intermediaries 2014
http://www.lawcom.gov.uk/wp-content/uploads/2015/03/lc350_fiduciary_duties.pdf

Scottish Law Commission: Report on Trust Law 2014
http://www.scotlawcom.gov.uk/files/4014/0904/0426/Report_on_Trust_Law_SLC_239.pdf

Nigel Griffiths QC opinion
http://www.lgpsboard.org/images/PDF/Publications/QCOpinionApril2014